May 2003
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Hungary: 2003 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **February 6, 2003,** with the officials of Hungary on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 1, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **April 30, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 2, 3003 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Report on Observance of Standards and Codes—Data Module—Update
Report on Observance of Standards and Codes—Fiscal Transparency—Update
Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Hungary

Approved by Carlo Cottarelli and Liam P. Ebrill

April 1, 2003

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Appendices

The 2003 Article IV consultation discussions were held in Budapest during January 23–February 6, 2003. The mission met with: President Járai of the Magyar Nemzeti Bank (MNB or the National Bank); Finance Minister Lászlo; senior officials in the MNB, government ministries, Hungarian Financial Supervisory Authority, and Parliament; trade unions; and representative of employers, and financial and research institutions.

The staff team was headed by Mr. Feldman, included Messrs. Berger, Drummond, and Kuijs (all EU1), and was assisted by Mr. Sassanpour (resident representative in Poland). Mr. Abel, of the office of the Executive Director for Hungary, participated in the discussions. Mr. Kiekens, Executive Director for Hungary, attended the concluding policy meeting.

Hungary again this year participated in the preparation of updates of the Report on Standards and Codes (ROSC) modules on the fiscal sector and data dissemination. Hungary meets the Special Data Dissemination Standard (SDDS) specifications. The concluding statement was published on the websites of the Ministry of Finance, the MNB, and the Fund.

Hungary has accepted the obligations of Article VIII.

In concluding the last Article IV consultation on May 22, 2002, Directors welcomed the well-managed introduction of the new monetary policy framework (i.e., the widening of the exchange rate band and introduction of inflation targeting, in line with staff advice), but emphasized the need for fiscal consolidation and public expenditure, including wage, restraint (areas in which advice was not subsequently followed). While various structural measures undertaken by Hungary have essentially left transition behind, recommended reforms in key areas of the fiscal domain are still needed to ensure a sustainable path of fiscal consolidation

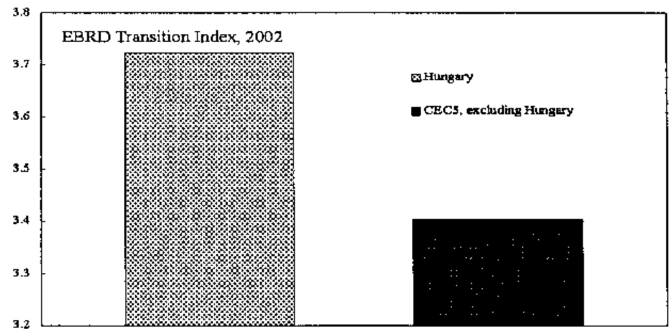
The center-left coalition led by the socialist party built on its narrow victory in the April 2002 parliamentary elections by scoring major gains in the local elections in October 2002.

Hungary is slated to join the EU in May 2004. A local referendum on EU membership is to be held on April 12, 2003.

I. Background

1. **Reflecting a remarkably successful transition, Hungary is now on the verge of EU membership.** Strong external competitiveness, export growth, and foreign direct investment (FDI) have been at the heart of Hungary's success (Figure 1). This success has also been backed by careful macroeconomic management and significant structural reforms, including the lasting effects of the bold reform measures of the early and mid-1990s (see text figure). However, with elections in 2002, fiscal policy was highly politically-charged and turned very expansionary, contributing to macroeconomic imbalances and an inordinate burden on monetary policy.

Hungary's record on structural reforms compares favorably



2. **Developments in growth and inflation were broadly positive in 2002** (Table 1; Figure 2, panels A-F). Real GDP growth, while slower than its rapid average pace during 1997–2001, picked up during the year. Buoyed by domestic demand, it increased to 3.6 percent (year-on-year) in the second half of last year from 3.0 percent in the first half. Headline inflation declined from its recent peak of 10.8 percent in May of 2001 (when the exchange rate band was widened) to 4.8 percent at end-2002.[1] As a result, the Magyar Nemzeti Bank (MNB or the National Bank) has essentially met two consecutive year-end inflation targets. Exogenous factors contributed to the decline in inflation, including lower food and fuels prices during this period. Core inflation also declined significantly.

3. **However, recent wage growth has been extremely rapid.** On an economy-wide basis, year-average wage growth was 18.3 percent in 2002 (Figure 2, panel C). This reflected continued strong wage growth in the private sector on the back of a 25 percent hike in the minimum wage early in 2002, which not only increased wages on its own but also compressed the wage scale leading to further upward wage pressure.[2] Rapid wage growth in the public sector also reflected the 50 percent wage increase in September for some three-quarters of the public work force (without any reform of public employment). The carryover effect of the public wage increase is significant—contributing to an increase in the wage bill of the general government in 2003 of 20 percent, even with the announced wage

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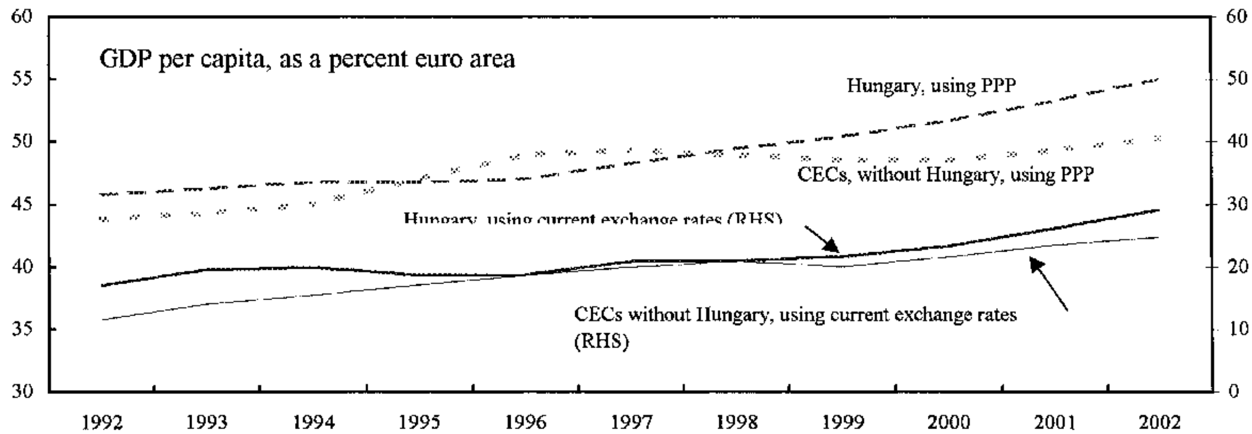
[1] It declined further to 4.7 and 4.5 percent, respectively, in January and February 2003.

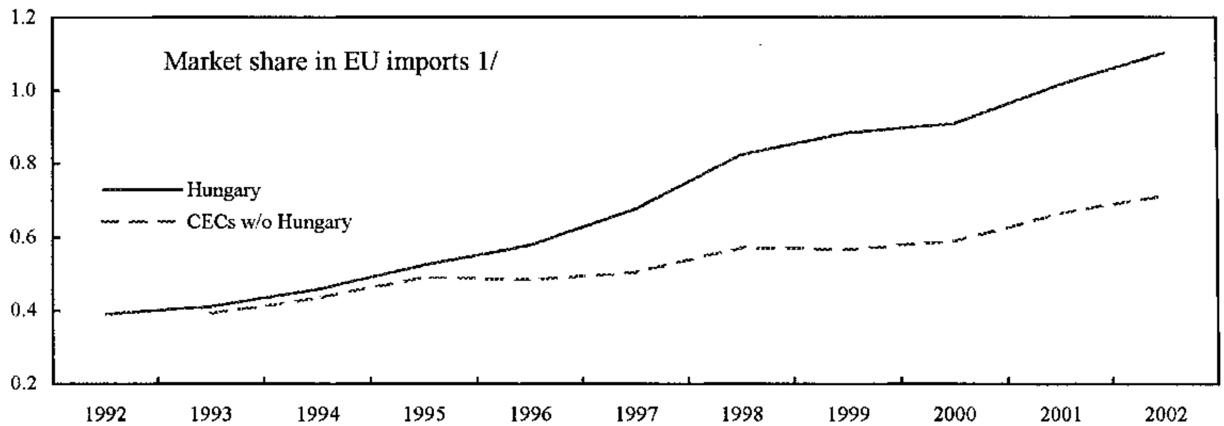
[2] The compression in the wage scale was particularly acute coming after a 57 percent increase in the minimum wage in January 2001.

Figure 1. Hungary: Transition and Export Performance, 1992-2002

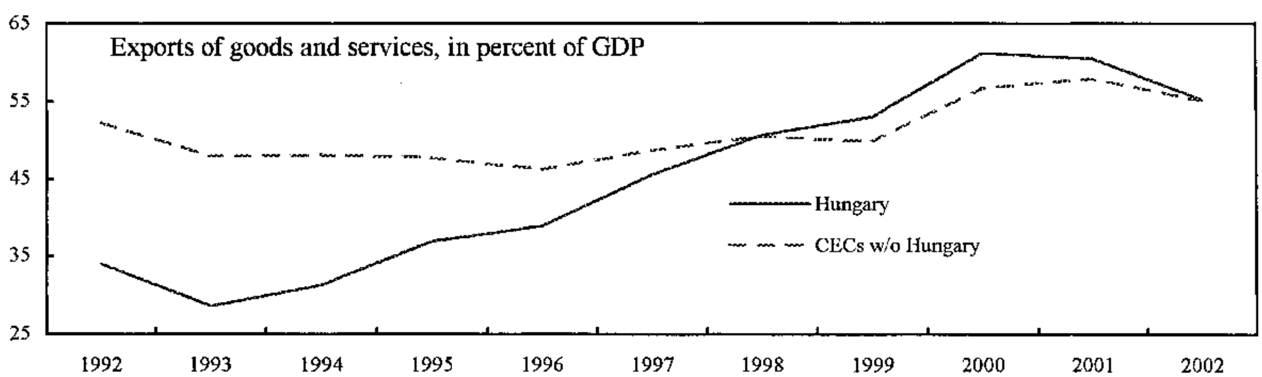
Hungary's transition has been successful...



...supported by a competitive export sector...



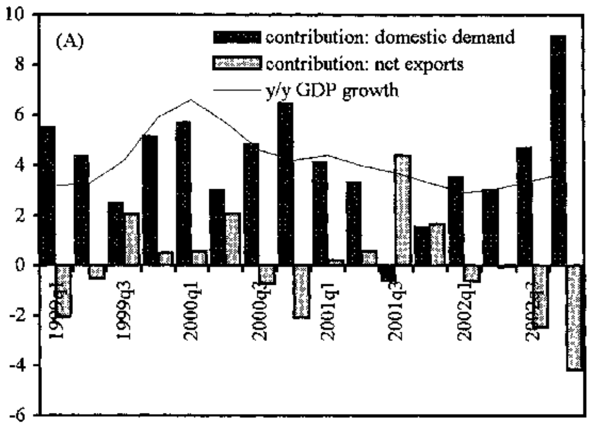
...though its relative size, while having increased steadily during 1993-2000, has fallen in recent years.



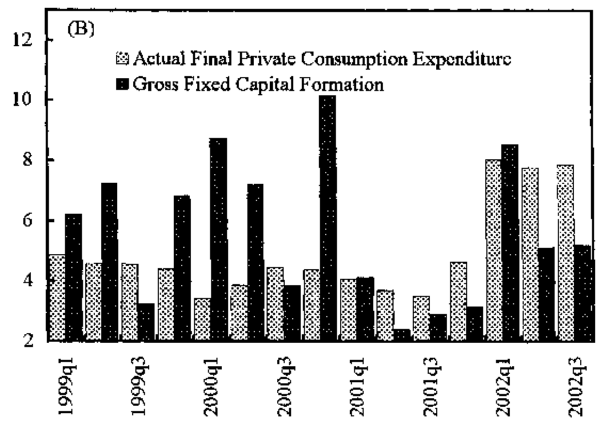
Sources: IMF World Ecnomic Outlook; IMF Direction of Trade Statistics; and staff calculations.
1/ Data for 2002 are based on the first three quarters of the year.

Figure 2. Hungary: Recent Developments, 1999-2002
(year-on-year growth, in percent, unless otherwise indicated)

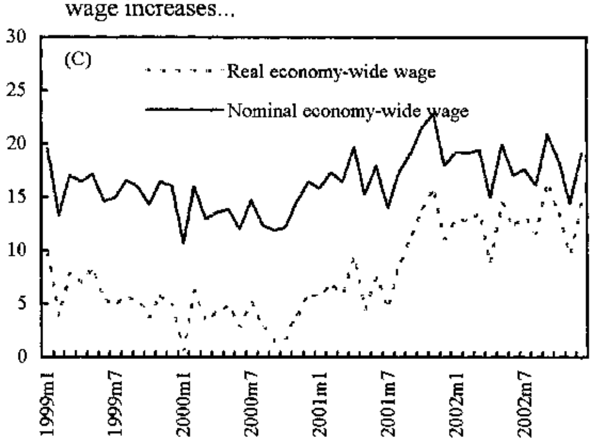
Growth has held up well, buoyed by domestic demand...



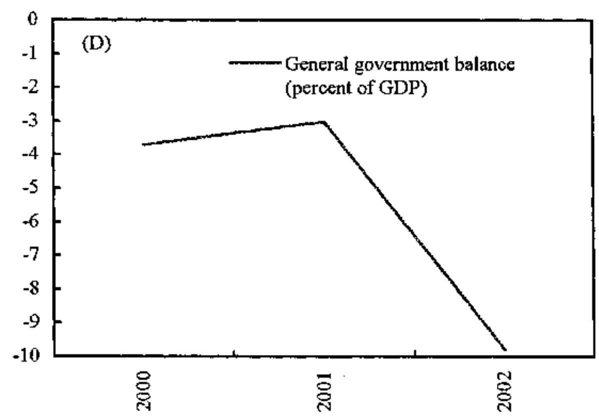
...with consumption particularly strong.



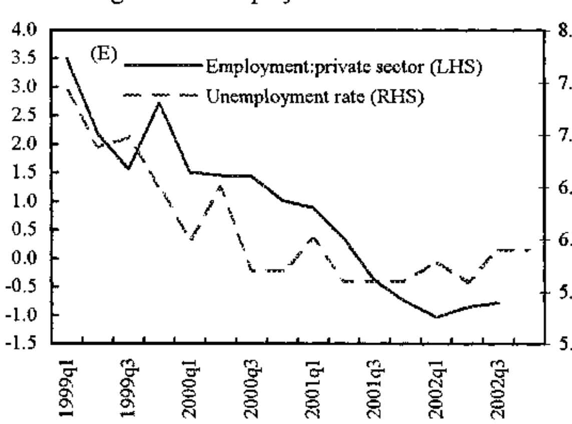
Household incomes have benefited from large wage increases...



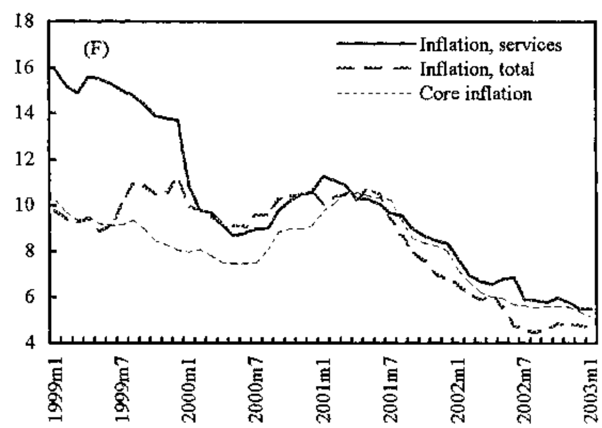
...while large wage and pension increases widened the fiscal deficit and raised domestic demand.



The wage hikes have also added to the impact of lower economic growth on employment...



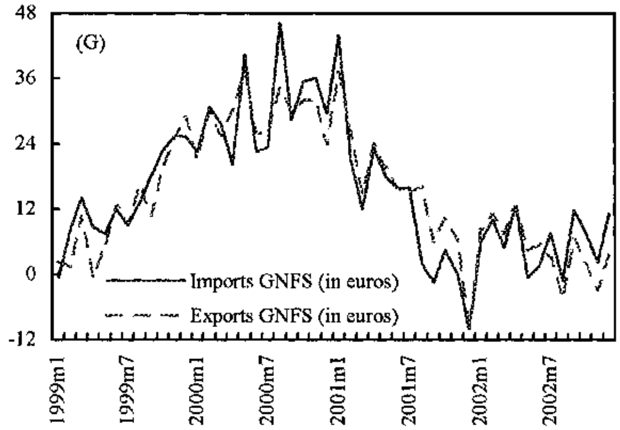
...and could put successful disinflation at risk.



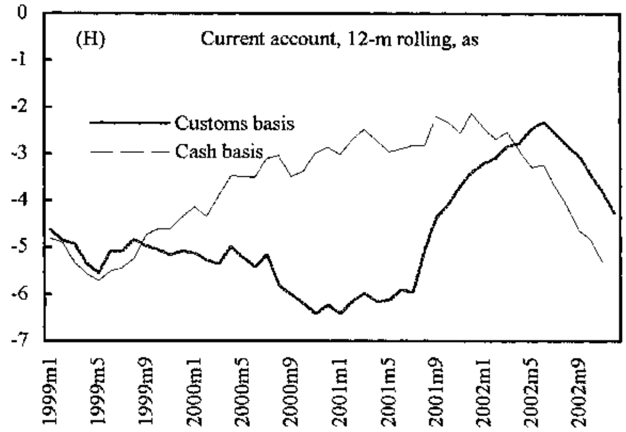
Sources: Hungarian authorities and staff estimates.

Figure 2. Hungary: Recent Developments, 1999-2002 (continued)
(year-on-year growth, in percent, unless otherwise indicated)

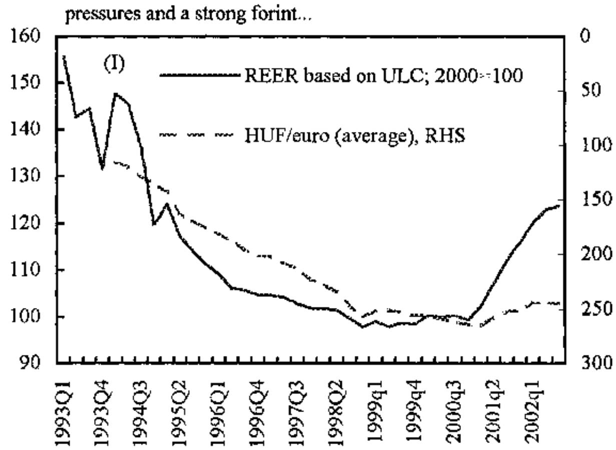
Exports have held up well, but imports have been boosted by strong domestic demand...



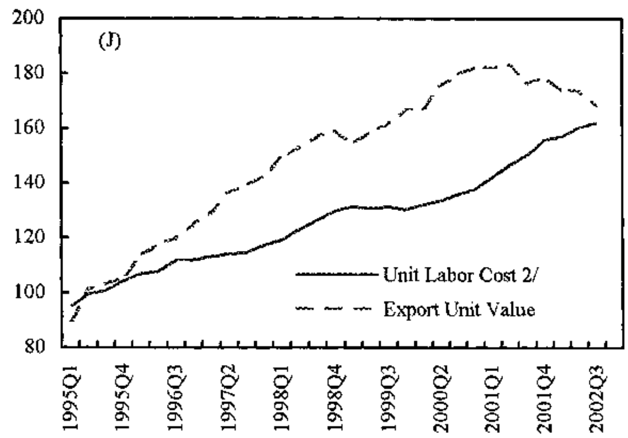
...increasing the external deficit.



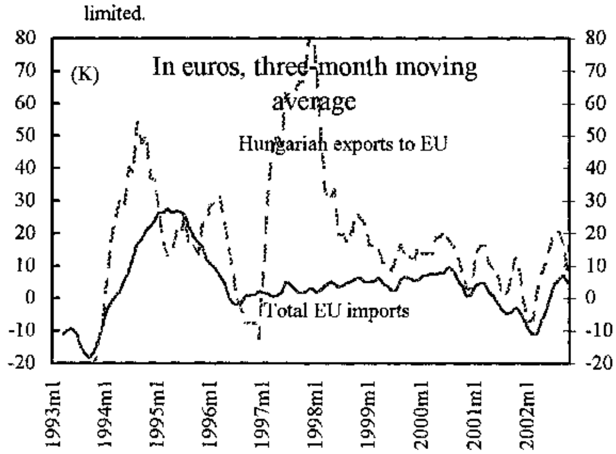
Competitiveness, albeit from a strong base, has been hit by wage pressures and a strong forint...



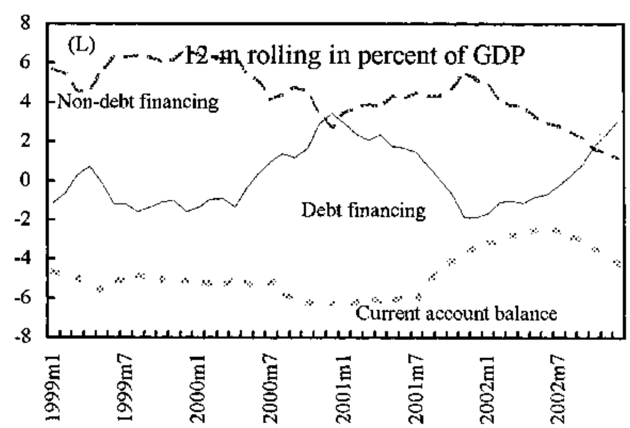
...affecting profits in the export sector in particular...



...even though the effects on exports have so far been limited.



Meanwhile, with FDI weak, the external deficit in 2002 was mostly financed by other sources.



Sources: Hungarian authorities; IMF Direction of Trade Statistics; and staff calculations.

1/ Includes short-term loans (by remaining maturity), and nonresident holdings of domestic bonds. Reserves are net of resident foreign exchange deposits with the MNB.

2/ ULC based on manufacturing sector (1995=100).

freeze for most public employees.[3] The demonstration effect on private wages and on wages in state-owned enterprises could also be considerable.

4. **Reflecting both wage increases and nominal exchange rate appreciation, external competitiveness declined significantly during 2001–02.** The ULC-based real effective exchange rate appreciated by some 20 percent during this period (Figure 2, panel I). About one-third of this appreciation was the result of the stronger nominal effective exchange rate. Some two-thirds of the appreciation reflected nominal wage growth in excess of the growth in productivity, and the resulting rise in Hungarian relative unit labor costs. Hungary has clearly lost some of its competitive edge as a result, and the loss of competitiveness associated with real exchange rate appreciation dampens export performance now and with a lag, and may also be adversely affecting FDI. Moreover, the loss of competitiveness would raise even more serious concerns about export prospects and FDI if rapid wage growth were to persist.

5. **The external current account deficit widened in 2002 while FDI fell off sharply.** Thus, the deficit was mostly financed by debt and a decrease in official reserves. Buoyed by real appreciation, wage increases, and a fiscally-induced strengthening of domestic demand, import growth was strong. At the same time, tourism receipts fell sharply. This resulted in a current account deficit of 4.1 percent of GDP, compared with 3.4 percent in 2001 (Table 2). These data reflect methodological changes to the balance of payments statistics that were introduced in late February (after the Article IV discussions) to bring them more in line with international best practices.[4] While these changes lowered the current account deficit by about one percent of GDP in 2002, the deficit would perhaps be some 2–3 percent of GDP larger if data on reinvested earnings were available and included in the official statistics. Moreover, the year-on-year growth of exports of goods and services slowed down considerably in the second half, and export volume actually may have turned negative in the fourth quarter.

6. **By any standard, fiscal policy was highly expansionary in 2002.** Compared with deficits (on an ESA-95 basis) of 3.0 percent of GDP in 2000 and 4.7 percent of GDP in 2001, the estimated deficit of the general government reached a startling 9.5 percent of GDP

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[3] This freeze excludes civil servants (12 percent of public employment, slated to receive a 2001-mandated increase of 15 percent in mid-2003) and judiciary employees (slated for 25 percent increases in both July and November).

[4] More details on the new methodology are provided in the statistical issues appendix, and the accompanying data ROSC update.

(Table 3).[5] While one-off expenditures amounted to about 3¾ percent of GDP,[6] there were significant permanent expenditure increases—notably on wages and pensions, as well as on health-related spending, social benefits, and subsidies. These increases not only added to the deficit last year, but they will also complicate fiscal consolidation efforts in this and later years.

7. **Fiscal laxity, alongside rapid wage increases, put monetary policy in a very difficult bind.** The MNB had set an end-2003 inflation target of 3.5 ± 1 percent, but rapid wage growth and fiscal expansion contributed to an increase in its baseline projection to above-target inflation, with upside risks predominating.[7] Against this background, and in the face of a widening external current account deficit and concerns over external competitiveness, the speculative attack against the exchange rate band in January (Box 1) brought to a head the conflict between inflation and external objectives, and the inconsistency in earlier macroeconomic policies.

Box 1. The Speculative Attack

- With the forint at the strong end of its ±15 percent band against the euro, it came under a massive speculative attack during January 15–16, 2003. With considerable stimulus from an expanding fiscal deficit and wages, speculators bet that the central bank (with needed legal consent from the government) would revalue the central rate to a stronger level or, absent a band, allow the exchange rate to appreciate, to meet the inflation target.

- To fend off the attack the MNB: lowered the base rate (i.e., the interest rate on two-week deposits) by 200 basis points to 6½ percent; undertook major intervention, accumulating large amounts of foreign exchange; widened the overnight interest rate corridor from the base rate ±100 basis points to ±300 basis points, thereby reducing the rate on overnight deposits from 7½ percent before the attack to 3½ percent; and imposed quantity limits on the two-week deposit facility, which forced funds to be shifted to the overnight facility and caused actual money market rates to fall significantly below the base rate.

- In the aftermath, the MNB has sold foreign exchange to mop up liquidity and help to unwind long forint positions; and, effective February 24, removed the limit on the two-week deposit facility and narrowed the interest rate corridor back to 100 basis points (while keeping the base rate at 6½ percent).

- The forint traded between 245 and 248 per euro in the last ten business days in March, compared with 245–250 before the monetary measures in mid-February and 234 at the strong edge of the band. (Figure 3 shows movements in exchange rates, interest rates, and reserves).

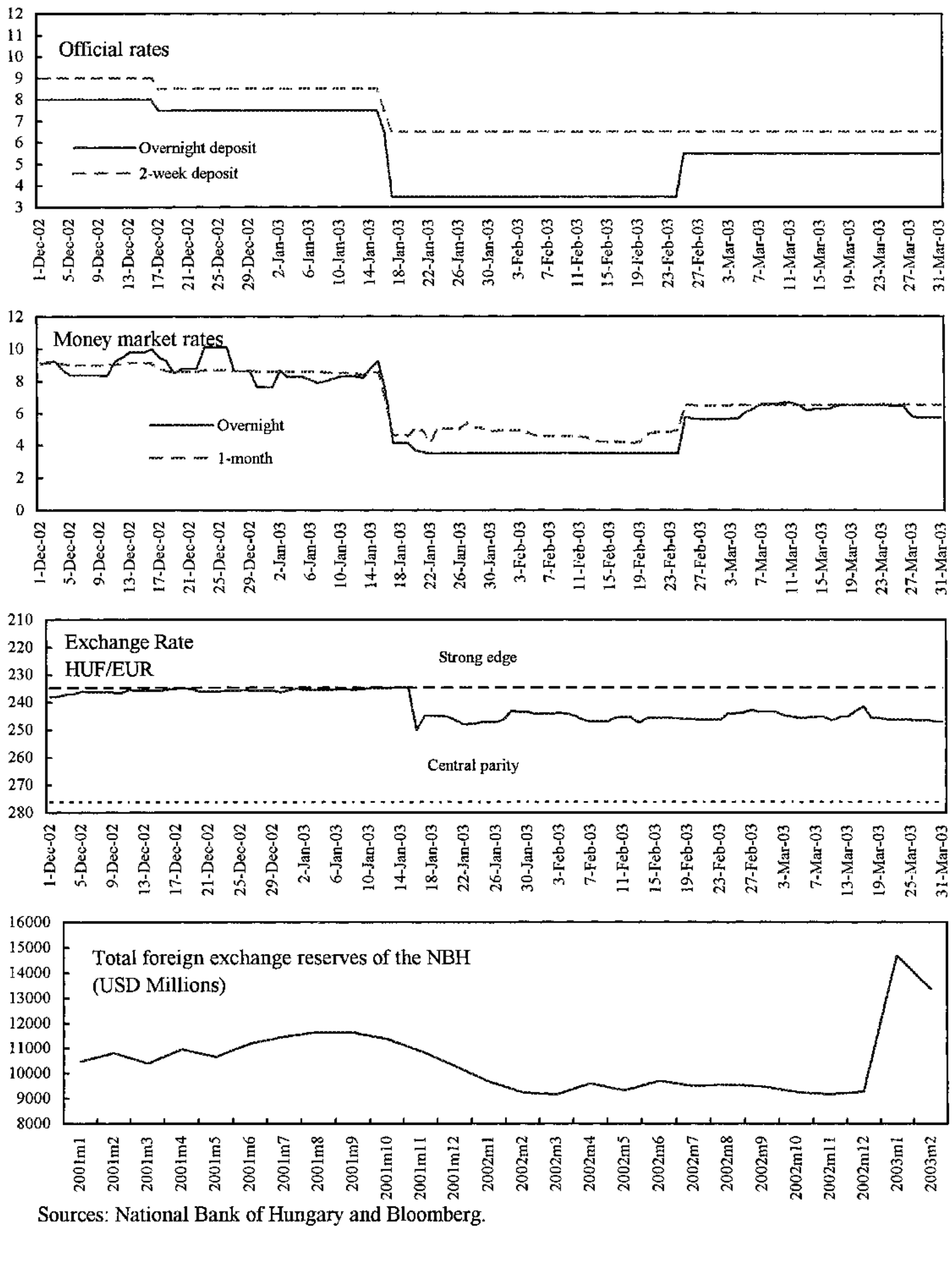
- The authorities noted that the impact of the recent speculative attack on banks' profits in Hungary was neutral to positive, and their small open foreign exchange positions kept risks low.

[5] On a GFS basis, the deficit was even larger at 9.8 percent of GDP. The difference between the two measures is expected to be small in 2003.

[6] These included recapitalization of public entities, debt assumption and take over, share purchases, and one-off capital and social transfers.

[7] See the *Quarterly Report on Inflation*, November 2002.

Figure 3. Hungary: Interest Rates, Exchange Rate and Foreign Reserves, 2001-2003



Sources: National Bank of Hungary and Bloomberg.

II. Report on the Discussions

8. **The discussions covered a number of issues.** These included the short-term outlook and the appropriate near-term setting of macroeconomic policies, as well as medium-term goals and the strategy for adoption of the euro. All agreed on the need to rebalance the policy mix—that is tighten fiscal policy with a view to unburdening monetary policy, thereby avoiding excessive monetary tightening, unwanted currency appreciation, and the inconsistent monetary/fiscal policy mix that was an important element leading up to the speculative attack on the strong edge of the currency band. An important aspect of the discussion on joining ERM-2 (upon acceding to the EU) and adopting the euro was the challenges faced by the authorities, particularly on the fiscal front, in progressing toward meeting the Maastricht criteria. The need for fiscal consolidation, and the associated policies to achieve it, have been a key feature of previous consultations.

A. Economic Outlook and Objectives

9. **For the most part, the outlook for this year was not a point of contention—though uncertainties were recognized.**

- ***Growth.*** The MNB's baseline real GDP forecast for 2003 is 3.5 percent (revised down from the 3.9 percent forecast made in November). This is similar to the staff's projection (and the consensus) of 3.6 percent. The figures of both the MNB and staff reflect a projected pick up in EU activity and exports, which also has a growing positive effect on private investment throughout the year. Private consumption, while strong, is projected to moderate in response to a slower pace of real wage gains than the torrid pace witnessed in 2002. These growth forecasts are below the 4.4 percent used by the Finance Ministry in preparing the budget (the latter being made in the fall of 2002), and estimates of potential output growth of about 4½ percent.[8]

- ***Inflation.*** With wage pressures still evident and the exchange rate having depreciated since the speculative attack, there was general agreement that inflation at end-2003 would be above the of 3½ ± 1 percent target. For this and other reasons, the MNB, in its latest *Quarterly Report on Inflation* (February 2003), projects inflation of 5.2 percent. This is in line with the staff's projection.

- ***External current account.*** Pressures that are expected to widen the current account deficit include continued sluggish growth in Hungary's trading partners, higher oil prices, and the lagged effects of the significant appreciation of the real exchange rate. The latest projection of the MNB foresees a widening of the deficit (using the old data methodology) of one-half percentage point of GDP.[9] Staff projects a widening of a similar magnitude, to a

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[8] The Finance Ministry revised its growth forecast to 4 percent in mid-March 2003.

[9] The MNB's projection was made before the change to a new methodology for compiling balance of payments statistics.

deficit of 4.8 percent of GDP using the new data methodology. A further increase in later years, or a sustained deficit of this size, would raise warning flags from a sustainability point of view, including because of the potential for unfavorable debt dynamics.[10] However, such problems are not expected to arise with the projected current account deficit on a downward trend in later years. While the authorities felt that a current account deficit of the size projected in 2003 should be easily financed, many of them agreed with staff that the risk of a (possibly disorderly) correction should not be ruled out were sizable twin deficits to prevail.

- ***Risks.*** With the balance of risks on growth on the downside—primarily reflecting the possibility of a weaker-than-expected recovery abroad, and therefore weaker export growth, confidence, and private investment—real growth may be below the forecasts of the MNB and staff, and thus well below what was used for the budget. These risks would also widen the current account, as would a continued increase in world oil prices. While slower growth would moderate inflationary pressures, as would lower oil prices, these risks are balanced on the upside by risks from wage behavior and the possibility of higher priced oil.

10. **The authorities' most recent Pre-Accession Program (PEP) lays out medium-term objectives and is broadly consistent with the staff's medium-term scenario.** That scenario (Table 4), which is based on achieving the targets for the deficit of the general government as set out in the PEP, illustrates containing the current account deficit in the face of rising private investment and some continued decline in private saving. The authorities emphasized, and staff agreed, that the fiscal targets specified in the PEP—which envisages deficits of the general government falling below 3 percent of GDP in 2005 (on an ESA-95 basis)—were necessary in their own right to support both domestic and external objectives, and to ensure a healthy degree of macroeconomic policy consistency. The targets are also consistent with early adoption of the euro. While external and public debt dynamics can be expected to remain broadly manageable under most stress tests, these dynamics would clearly be less favorable if downside external risks were to materialize, or fiscal policy to loosen significantly, a concern especially in light of relatively high debt ratios (Tables 5 and 6).

11. **Euro adoption can provide an important anchor for the macroeconomic framework over the medium term.** Moreover, a number of considerations related to the criteria for optimal currency areas support Hungary's readiness for adopting the euro: degree of openness, trade (and financial market) integration, synchronization of business cycles; and nominal price and wage flexibility.[11] Reflecting these considerations and the findings of a

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[10] An accompanying selected issues paper on external sector issues discusses sustainability in more detail.

[11] These are discussed in detail in "Is Maastricht Too Much for the Candidate Countries?," a MNB working paper.

recent study,[12] the MNB has argued for adoption of the euro as early as possible—which most recently has been taken to mean 2008 in light of the setbacks to fiscal adjustment and disinflation. The Finance Minister has expressed the view that Hungary should seek to adopt the euro as early as 2007 but no later than 2009. For its part, staff sees considerable merit in early adoption of the euro, provided fiscal discipline and wage restraint (discussed below) are vigorously pursued. Staff emphasized, and the authorities agreed, that in formulating and communicating the macroeconomic policies required to meet the Maastricht criteria in a sustainable way, care must be taken to avoid the potentially disruptive effects of abrupt shifts in market expectations on the progress toward adopting the euro. In this context, staff welcomed the establishment of a working group of the MNB and the Ministry of Finance, which is an important step in promoting collaboration and progressing with needed preparatory work, and in building consensus on a euro strategy.

B. Fiscal Policy

12. **The need for fiscal adjustment was not at issue.** There was consensus that significant fiscal tightening would lessen the necessary degree of monetary restraint to meet the end-2004 and later inflation targets, and thereby help to avoid too strong an appreciation of the exchange rate. All agreed that fiscal adjustment would also contribute to raising national saving to support investment while avoiding crowding out private sector investment; safeguarding public debt and external viability; and generally maintaining macroeconomic stability important for sustaining growth. The authorities stressed, additionally, their goal of reverting back to investment growing more rapidly than consumption, a goal that requires wage moderation.

13. **While quite large on face value, the targeted fiscal adjustment in 2003 is feasible—though not without implementation risks.** The authorities aim, on an ESA-95 basis, to reduce the fiscal deficit from 9.5 percent of GDP in 2002 to 4.5 percent this year. The adjustment would be somewhat larger on a GFS basis. Since the targets for 2003 (and later years) are ESA-based but more detail is available using GFS, Table 3 reports the fiscal accounts both ways.

- On revenues, the budget foresees a decline of 1.2 percentage points of GDP, with a reduction in personal income taxes (reflecting the tax exemption for the minimum wage and revised tax brackets) and social security contributions (reflecting a decline in the lump sum payment for health) contributing 0.8 percentage point and the rest associated with changes in non-tax revenue. Staff felt that these revenue estimates were, on the whole, achievable. Staff saw downside risks from optimistic projections for the base for the personal income tax and social security contributions, and from the possibility of lower real growth than assumed in the budget. However, the effects of the latter would be mitigated to the extent that lower growth reflects lower exports and investment, since the direct impact on budgetary revenue would be

[12] An MNB occasional paper entitled *Adopting the Euro in Hungary: Expected Costs, Benefits, and Timing.*

relatively small. Meanwhile, the upside to wage growth and inflation, while undesirable for other reasons, would tend to have a significant positive impact on revenues.

- In light of the budgeted decline in revenue, total expenditures need to fall by 6½ percentage points of GDP (and somewhat less on an ESA-95 basis). The fading out of one-time outlays contributes some 3¾ percentage points to this adjustment.[13] Interest expenditure drops by almost a half percentage point of GDP. Capital expenditure (which in the GFS table includes only part of central and local government capital expenditure) accounts for another one percentage point. The authorities explained that the remaining adjustment mainly reflects further restraint on investment, including road construction.[14] The residual categories of current primary spending will also need to be contained at a lower level (as a percent of GDP) than in 2002, consistent with budget appropriations. Unwavering policy implementation will be required on this score.

- The representatives of the Ministry of Finance saw particular upside spending pressures in the areas of open-ended housing grants and other subsidies. They also explained that, based on budget execution during the first half of the year, a decision would be made in July on any needed corrective measures to realize the fiscal deficit target.

- The resulting fiscal withdrawal from meeting the deficit targets would be coming on the heels of the huge fiscal stimulus in 2001 and 2002, some of which came in the last months of 2002. As a consequence, the effects would be felt in 2003 and partially offset the fiscal withdrawal. Moreover, fiscal withdrawal is limited further because some one-off measures had little demand impact (e.g., debt consolidation operations) and the impact of others was limited by their temporary nature. Finally, the fiscal stance is not expected to unduly crunch the economy because the fiscal multiplier can be expected to be small in a small, highly open economy like Hungary.

14. **2004 is a pivotal year in which the authorities will be confronted with a number of challenges in achieving the deficit target of 3 percent of GDP.** With the adjustment in 2003 relying mostly on one-off factors and lower investment spending, the case for preparing early for more durable fiscal adjustment in 2004—focusing on current expenditure—was well recognized. The discussions revealed a number of considerations in 2004 that strengthen the case for strong restraint on current spending. First, spending pressures arise from public investment needs—so there is unlikely to be much in the way of saving in this area, although

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[13] There are also additional one-off expenditures, that would contribute another ¾ percentage point, but they are excluded from this decomposition because they are offset by budgeted rises in the same category (e.g., for pensions, the fading out of one-time increases is more than offset by mandated hikes).

[14] This, in turn, reflects investment activities by the general government other than the central and local authorities, which, although public investment, are dispersed in expenditure categories other than capital spending in Table 3a.

some measures could enhance expenditure efficiency (e.g., international public tenders for large infrastructure projects). Second, EU membership entails a considerable reduction in import duty revenues and significant EU-related spending. Third, measures to reduce the high tax wedge on labor have already been approved with the 2003 budget.

15. **Working with the authorities, and drawing on technical assistance from the Fiscal Affairs Department, a menu of options was identified.** As shown in the table below, these options exceeded the overall requirements for meeting the fiscal target in 2004 (and later years).[15] In addition, it will be important to limit transfers to and guarantees for state-owned enterprises, including to ensure that new "one-off" spending items do not occur. The authorities agreed that there is a need for expenditure policies and reforms in a number of areas, and they will be working to identify priority areas. The experience of other European economies in undertaking significant fiscal adjustment is relevant to the task at hand. Staff stressed that the evidence suggests that fiscal consolidation is durable and more friendly to growth when it relies more heavily on restraining spending than increasing revenue, and tackles key issues related to the government wage bill, transfers, and subsidies.[16]

Menu of Expenditure Reform Options and Estimates of their Potential Budgetary Savings (In Percent of GDP)

Reform Options	Savings
Government employment and wages	
(hiring freeze and abolition of unusual benefits)	0.30
Health care (mainly introduction of co-payments)	0.5
Education (notably to obtain economies of scale)	>0.7
Pension reform (including revisions to formulas and eligibility)	0.8-1.1
Social benefits (reduction and better targeting of benefits)	0.50
Reform of government subsidies	0.8-1.0
(housing, transport, and pharmaceuticals)	
Total	**>3.6-4.1**

16. **The authorities raised some key proposals for strengthening fiscal management.** The Ministry of Finance was planning to introduce three-year rolling expenditure ceilings to serve as a basis for medium-term budget planning. These would be established for major budgetary chapters, with leeway for ministries to allocate spending within these chapters. In line with rules governing the disbursement of EU cohesion and structural funds, the framework would include explicitly the government's medium-term goals and commitments in areas related to the absorption of EU funds. Though the details had not yet been fleshed out, the authorities also proposed to move toward performance-based budgeting (e.g., through the specification and quantification of the expected results of spending programs) in

[15] This excludes potential savings on expenditures on "other goods and services" in the various sectors reviewed. Usually, some expenditure savings may be achieved by rationalizing procedures and strengthening audit and control.

[16] An accompanying selected issues paper on fiscal policy discusses these issues in more detail.

the context of improved transparency in the fiscal area. This would facilitate greater public surveillance of fiscal activities and could thereby promote a more efficient delivery of public services.

17. **Staff reacted positively to the authorities' proposals, when viewed as part of a coherent overall fiscal and macroeconomic framework.** A key defining feature of medium-term frameworks, in contrast to simple medium-term projections, is their formal status within the annual budget process. Thus, staff strongly agreed that an essential feature should be submitting these ceilings to parliament for approval at the time of the budget, and emphasized the importance of including a statement of policy objectives to help garner broader support.[17] In addition, in circumstances in which fiscal adjustment is vital, staff encouraged the use of realistic but conservative assumptions, with a view to erring on the side of fiscal overperformance. Staff strongly welcomed the actions taken to improve fiscal transparency.[18]

C. Wage Policy

18. **The authorities explained the desired outcome of the wage guidelines for the private sector in 2003.** In particular, the National Interest Coordination Council (a tripartite group consisting of the government, employers, and unions that makes wage recommendations) had recommended an increase in net real wages of 4.5 percent in 2003 for the private sector. The government saw this as compatible with an increase in nominal gross wages of 5–6 percent, on average, taking into account the reductions in the personal income tax and social security contributions.[19] It was also hoped by the authorities that diminishing profit margins on the heels of the large appreciation of the forint in 2001–02 would keep wage pressures in check. However, translating the Council's recommendation into a gross nominal wage increase requires a detailed calculation for each employee that would depend, in part, on income levels. Inflationary expectations could also differ considerably across economic agents, diminishing the clarity of the recommendation. The most recent projections by the MNB, at 8 percent, are higher than the 5–6 percent targeted by the government. Discussions with labor unions added credence to the higher figure.

19. **Recognizing that wage moderation is key to supporting disinflation and external competitiveness, the discussion turned to ways to achieve this.** In the first instance, staff

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[17] The accompanying selected issues paper on fiscal policy also provides more detail on desirable features of medium-term expenditure frameworks.

[18] These are described in the accompanying fiscal ROSC update.

[19] At one extreme, assuming expected inflation of 5 percent for simplicity, the recommendation for net real wages would translate into a 1.8 percent increase in nominal gross wages for a low-income worker earning 75,000 forint (for whom tax reductions are the most significant).

agreed that the government needed to signal the importance it attaches to wage moderation through its wage policy for public sector employees. Thus, on the heels of the wage increases already granted, staff strongly supported the wage freeze this year for the vast majority of public sector employees, and urged the government to consider keeping wage increases in 2004 below the inflation target. Staff also saw merit in closer cooperation among the social partners—working through, say, the National Interest Coordination Council—to reach a broader consensus on wage moderation. In this regard, the experience of some current members of the euro area was of relevance: in several countries (e.g., Greece, Ireland, and Portugal), wage agreements were instrumental in bringing down inflation to meet the Maastricht criteria. Moreover, staff agreed with the MNB that recommendations should be made in (gross) nominal rather than real terms. This would make it easier for the various players to translate recommendations into actual wage increases. It would also discourage backward-looking indexation, which adds inertia to inflation and makes it more difficult to disinflate.

D. Monetary Policy and the Exchange Rate

20. **Monetary policy has operated in a constrained and difficult environment.** In the aftermath of the attack on the strong edge of the exchange rate band, the MNB rightly wanted to reverse the increase in base money and negative short-term real interest rates at the earliest opportunity in order to limit the potential for dissaving and a rekindling of inflationary pressures. It also wanted appropriately to sell foreign exchange to mop up liquidity and help to unwind long forint positions from the attack, and return to normal operating procedures (and transmission from official to market interest rates). As indicated in Box 1, the MNB has taken some necessary actions—and current conditions would not seem to particularly warrant a change in official interest rates now. But the central bank will have to be vigilant, yet pragmatic, to avoid undesirable consequences because of the remaining liquidity from the speculative attack, including by undertaking further sales of foreign exchange and sterilization operations. However, the scope to affect the inflation outturn for 2003 is limited, both in light of the lags involved in monetary transmission and because of the limited room for maneuver after the attack, with the inflation target essentially subordinated to exchange rate considerations for now. Thus, in a process that is already underway, the authorities have begun to shift their focus to the end-2004 target and the supporting policies to achieve it.

21. **The inflation target for end-2004 can be achieved—but monetary policy cannot do it alone and keep the exchange rate close to current levels.** The president of the MNB has emphasized that he would prefer to avoid a strengthening of the forint from current levels. The Finance Ministry shares this view in light of its concerns about the competitiveness of the external sector. Staff's analysis raises warning flags about overvaluation.[20] With the MNB's latitude to tighten monetary conditions constrained in this way, support from fiscal policy and wages is all the more essential. Indeed, the MNB projection of end-2004 inflation of 4 percent hinges on a significant deceleration of private sector wage growth to 5½ percent in 2004 and on achieving the fiscal deficit target for that

[20] See the accompanying selected issues paper on external sector issues.

year. In view of the limited room for maneuver for monetary policy, the authorities agreed that deviations from the fiscal adjustment announced in the PEP, and from a tight incomes policy in the public sector could hurt the credibility of the disinflation path.

22. **Challenges will surely arise in the run-up to ERM-2 and adopting the euro.** In current circumstances, with concerns about external competitiveness, staff concurred with the authorities that the best outcome would be if the current exchange rate band could be maintained through the run-up to ERM-2. While this, for the time being, would compromise inflation objectives (absent unexpected favorable shocks to prices), monetary policy could be afforded more room for maneuver once officially in ERM-2, perhaps in the second half of 2004. In view of lags, this would help to progress on the Maastricht inflation criterion looking ahead to 2005. At the same time, with the European recovery (and fiscal adjustment) hopefully more firmly in train, external objectives would be less pressing. Adoption of the euro in, say, 2008 would require meeting the Maastricht inflation criterion towards the end of 2006.[21] While challenging, this should be feasible, provided monetary policy, aided by fiscal consolidation and wage moderation, can be better geared to inflation objectives. While Balassa-Samuelson effects may still be present, they may amount to roughly 1 percent according to some at the MNB, which could be handled, in part or in whole, by exchange rate appreciation within ERM-2, or within the margin allowed by the Maastricht inflation criterion. That being said, a smooth passage is by no means assured—and over time more room for currency appreciation may be needed. In any event, as EU accession and the chance to officially enter ERM-2 approaches, renewed speculation may occur, on a revalued central parity. It was agreed that formulating (internally) a clear strategy for euro adoption, and communicating credible macroeconomic policies to achieve it (without being specific too early on the timing and details of entering ERM-2) can only help. Indeed, euro adoption will only be a success if low inflation is achieved as a result of a credible monetary policy and successful and durable fiscal consolidation.

E. The Financial Sector

23. **The Hungarian financial system remains fundamentally sound.** In 2002, banks remained adequately capitalized and liquid; profitability was solid; and, while the quality of their loan portfolio deteriorated modestly, it still remained high. Moreover, as shown in Table 7, the level of international reserves is comfortable, especially as measured by the ratios to short-term debt and broad money. Potential areas of vulnerability—flagged in last year's follow-up to the Financial System Stability Assessment—are still relevant.[22] These include the concentration of bank credit to a handful of large borrowers and some lingering reluctance by the corporate sector to hedge against foreign exchange risks (although hedging activity is reportedly on the increase). These also include the fast growth of consumer lending (though from a low base), including mortgage lending (fueled by open-ended and

[21] Based on WEO projections, an inflation rate of 2.8 percent or less would be consistent with this criterion.

[22] Financial System Stability Assessment (FSSA) follow-up, IMF country report 02/112.

unsustainable government interest subsidies). In addition, despite rising vacancy rates and falling rental fees on commercial properties, business property loans continued to grow rapidly (but also from a low base). The authorities are keenly aware of all this and monitor the relevant information closely—including through the MNB's semi-annual *Report on Financial Stability* and the Hungarian Financial Supervisory Authorities' (HFSA) on-site inspections.

24. **The authorities noted a number of steps to strengthen the framework for financial supervision.** First, while consolidated supervision by the HFSA awaits full legal fortification, the HFSA is already performing its supervision on a consolidated basis. The HFSA indicated that they expect full legal backing to pass the parliament during the first half of this year. Second, the new Insurance Act—also expected to be adopted by parliament in the first half of 2003—will harmonize legislation with that of the EU in this area. Third, an amendment to the anti-money laundering law was pending (during the consultation discussions and was passed in late February), with a view to increasing efficiency in the fight against money laundering. In particular, the new legislation modified the definition of terrorist action and supports improvements in the operation and surveillance authority of the Financial Intelligence Unit. Implementation of the existing legislation on anti-money laundering has been strengthened (e.g., in the area of foreign exchange bureaus).

F. Structural Reforms

25. **Staff supported recent structural initiatives by the authorities.** Building on the impressive privatization successes in the 1990s, in which most of the economy was privatized, the government has earmarked state-owned companies with an estimated market value equivalent to about 1½ percent of GDP for further privatization this year, including a large bank. This is welcome and would help to increase FDI. In addition, progress has been made in opening the electricity market and eliminating subsidies as a result of raising regulated prices by about 10 percent in February. The latter, according to Energy Office estimates, will close the gap between costs and revenues at the state-owned grid-operator and public wholesaler. With respect to natural gas, prices for industrial users are about at world market levels. For households and other small users, the price rises scheduled for 2003 will move prices closer to, but not at, world market levels. Through a system of "block" prices, whereby the price charged increases with usage, the authorities intend that the basic needs of households will be met at lower prices while lessening distortions.

26. **Staff noted Hungary's progress in implementing current WTO agreements and in adjusting to the requirements of EU accession.** Following commitments made during the Uruguay round, the "tariffication" of non-tariff import limits on agricultural products has advanced further and industrial tariffs were lowered significantly. Further tariff reductions are in store due to EU accession. While implying higher import levies in some cases, putting the EU customs regime into operation will reduce the average tariff for industrial goods from about 7 percent to about 4 percent, and on agricultural products from about 22½ percent to about 20 percent.

G. Transparency and International Standards

27. **In addition to the progress made in the fiscal area, Hungary has made further progress in the area of economic statistics.** The authorities have addressed a number of data quality issues in the national accounts, monetary statistics, and balance of payments statistics. The authorities have also confirmed their aim to move the latter to a full accrual basis, including by showing reinvested earnings in the current account, starting with the release in early 2004 of the annual data for the preceding year.[23] However, analysis of fiscal issues would be helped by more timely and consistent data, including on public expenditures classified on an economic and functional basis.

III. Staff Appraisal

28. **With its track record of far-reaching institutional and structural reforms, and its successes in macroeconomic management, Hungary is on the verge of EU entry.** Provided that fiscal consolidation and wage restraint are vigorously pursued, aiming for early adoption of the euro has considerable merits. Hungary is already highly integrated with the EU, and stacks up favorably against optimal currency area considerations. Moreover, the goal of early adoption would be an important disciplining force for delivering needed macroeconomic policies that would be helpful irrespective of the Maastricht criteria. Against this background, staff welcomes the establishment of a working group to build consensus on a euro strategy and looks forward to its recommendations by the second half of this year.

29. **Some recent developments carry risks if left unattended.** Wage growth has been extremely rapid and has significantly eaten into external competitiveness. At the same time, absent offsetting action, the external current account is headed into unwelcome territory and could become especially troublesome without action to reduce the fiscal deficit, which at over 9 percent of GDP in 2002 was excessively large. While it is tempting to assume that the current account deficit will continuously be financed on favorable terms, not least in light of the market's exuberance over EU accession, market expectations can change unexpectedly. Were sizable twin deficits to prevail, the risk of a (possibly disorderly) correction should not be overly discounted.

30. **In the face of fiscal expansion and rapid wage increases monetary policy had to navigate very difficult straights.** With upside risks to inflation predominating, the speculative attack against the band in January, in the face of a widening current account and concerns over competitiveness, brought to the fore the conflict between inflation and external objectives. While it would have been preferable if the turmoil could have been avoided, the response by the MNB at the time of the attack was appropriate. Nevertheless, the basic problem remains: monetary policy by itself cannot aim simultaneously to lower inflation and support external competitiveness and adjustment.

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[23] See the accompanying data and fiscal ROSCs for more details.

31. **Against this background, staff strongly supports the authorities' fiscal deficit targets, which call for sizable and early consolidation.** The 2003–04 period offers the best opportunity to press ahead with the bulk of fiscal adjustment, ahead of the next election cycle. Achieving the deficit target as from its first budget would support the credibility of the new government and would be an important first step toward medium-term fiscal adjustment. In addition, major fiscal adjustment, now and in the medium term, is necessary to ensure continued disinflation and adoption of the euro, to minimize the chance of a disorderly external correction, and to set the stage for sustained economic growth. However, absent new measures, there are risks that the fiscal deficit target for 2003 will not be achieved. In light of the importance of upfront fiscal adjustment, corrective actions should be taken if slippages were to appear likely. Moreover, with a view to securing durable fiscal adjustment of a growth-friendly nature, it is important to prepare early for 2004—focusing on restraining current expenditure and structural reforms to achieve this in various areas, including public employment, health care, pensions, social benefits, and various subsidies. In support of fiscal consolidation in 2004 and later years, staff is positive about the proposal to introduce medium-term expenditure ceilings. These should hit at the core areas where restraint is needed, and be submitted to parliament for approval at the time of the budget, along with a supporting policy statement.

32. **Wage moderation is another key component to securing further disinflation and supporting external competitiveness.** Efforts on this front must begin in the public sector, with the government signaling the importance it attaches to this goal through its wage policy for public sector employees. In this regard, on the heels of the significant wage increases already granted, staff strongly supports the wage freeze for this year for the vast majority of public sector employees, and urges the government to keep wage increases in 2004 below the inflation target. Drawing on the experience of current members of the euro area, closer cooperation between the social partners to achieve wage agreements to bring inflation down to the Maastricht criteria should be seriously explored. Staff would also recommend that wage guidelines be set in (gross) nominal rather than real terms.

33. **With support from fiscal policy and wage moderation, monetary policy can achieve key objectives.** In the near term, the scope to affect the inflation outturn for 2003 is limited because the inflation target is essentially subordinated to exchange rate considerations. However, barring unforeseen and sizable adverse shocks to prices, the end-2004 inflation target is within reach, and the authorities have rightly shifted their focus to that target and supporting policies to achieve it. Deviating from a tight incomes policy and the envisaged fiscal deficit path, would clearly make it difficult to achieve inflation objectives without compromising external competitiveness. In the aftermath of the speculative attack, the MNB took appropriate actions to restore normal operating procedures. The central bank reversed the increase in base money and negative short-term real interest rates in order to limit the potential for dissaving and a rekindling of inflationary pressures, and current conditions would not seem to particularly warrant a change in official interest rates now.

34. **The financial system in Hungary continues to be fundamentally sound.** Risks to financial sector stability are well contained, with progress continuing in the regulatory and

supervisory frameworks (including anti-money laundering). The potentially vulnerable areas in an otherwise healthy financial sector include the rapid growth in consumer, business property, and mortgage lending, the later being fueled by open-ended and unsustainable government interest subsidies, and lingering concerns over whether the business sector is adequately hedged against foreign exchange risks. Importantly, the authorities are aware of these risks and monitor them carefully, including through the work on the MNB's *Financial Stability Report*, and the activities of the HFSA.

35. **Recent structural reform initiatives are encouraging.** Staff welcomes plans to complete privatization. The increase in the regulated price of electricity and the elimination of subsidies that is intended to go along with this increase are also important steps forward. Finally, while natural gas prices for households and small users still have a way to go before reaching world market levels, recent actions are on the right track.

36. **Hungary's continued participation in updating the ROSC modules as part of this year's Article IV consultation is testament to its commitment to transparency and standards.** Progress in fiscal transparency, including in compiling the fiscal accounts on an ESA95 basis, is most welcome and facilitates better monitoring and surveillance of the activities of the general government. The provision of more timely data on public spending by economic and functional classifications would facilitate further more efficient fiscal management. Improvements are notable in other areas too, including in compiling national accounts and balance of payments statistics, with a view to bringing these data more in line with international best practices. Looking ahead, staff looks forward to the inclusion of reinvested earnings in the balance of payments statistics by early 2004.

37. The next Article IV consultation with Hungary should remain on the 12-month cycle.

Table 1. Hungary: Main Economic Indicators

	1999	2000	2001	2002 Prel.	2003 Staff Proj. 1/
Real economy (change in percent)					
Real GDP	4.2	5.2	3.8	3.3	3.6
CPI (average)	10.0	9.8	9.2	5.3	5.3
Unemployment rate (in percent)	7.0	6.4	5.7	5.8	6.0
Wage Growth (gross wages)					
Economy wide	16.1	13.5	18.0	18.3	...
Private	14.8	14.2	16.3	13.3	...
Public	19.2	12.3	22.4	29.2	...
Gross national saving (percent of GDP)	23.4	24.9	23.9	22.2	21.1
Gross domestic investment (percent of GDP)	28.5	31.1	27.3	26.3	25.9
General government (percent of GDP), ESA-95 basis 2/					
Balance	...	-3.0	-4.7	-9.5	-4.5
Debt	61.0	55.4	52.4	56.8	55.3
Money and credit (end of period, percent change) 3/					
M3 4/	13.1	18.1	17.1	9.5	14.2
Credit to non-government 4/	21.5	34.8	18.2	22.2	22.7
Interest rates (percent)					
T-bill (90-day, average) 4/	14.6	10.8	10.7	8.8	6.1
Government bond yield (5-year, average) 4/	11.8	9.1	8.5	7.7	6.5
Balance of payments					
Trade balance (percent of GDP)	-4.5	-6.2	-4.3	-3.3	-4.0
Current account (percent of GDP)	-5.1	-6.2	-3.4	-4.1	-4.8
Reserves (months of imports of goods and services) 5/	4.1	3.7	3.3	2.7	3.8
Net external debt (percent of GDP) 6/	22.5	25.4	23.4	23.2	...
Fund Relations (February 28, 2003)					
Fund holding of currency (in percent of quota)				58.1	
Holdings of SDRs (in percent of allocation)				...	
Quota (SDR million)				1,038.4	
Exchange rate					
Exchange regime	Peg against euro, with band +/-15 percent				
Present rate (March 31, 2003)	Ft 226.5 = US$1				
Nominal effective rate (1990=100)	35.9	34.1	36.2	36.6	...
Real effective rate, CPI basis (1990=100)	135.2	136.0	146.8	162.9	...

Sources: Hungarian authorities, IFS, and staff estimates.

1/ These projections assume the government achieves its fiscal deficit target for 2003.
2/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments.
3/ For more details on monetary developments, see Table 8.
4/ Data for 2003 are as of end-February.
5/ Data for 2003 are as of end-February and expressed in terms of imports in 2002.
6/ Including inter-company loans, and nonresident holdings of forint denominated assets.

Table 2. Hungary: Balance of Payments, 1998-2005 1/

	1998	1999	2000	2001	2002 Prelim.	2003 Proj.	2004 Proj.	2005 Proj.
	(In billions of U.S. dollars)							
Current account balance	-2.2	-2.4	-2.9	-1.8	-2.7	-3.9	-4.0	-4.1
in percent of GDP	*-4.7*	*-5.1*	*-6.2*	*-3.4*	*-4.0*	*-4.8*	*-4.6*	*-4.4*
Merchandise trade balance	-1.9	-2.2	-2.9	-2.2	-2.1	-3.3	-3.5	-3.7
in percent of GDP	*-4.0*	*-4.5*	*-6.2*	*-4.3*	*-3.2*	*-4.0*	*-4.0*	*-3.9*
Exports goods	23.7	25.6	28.7	31.1	34.8	38.8	41.1	43.9
percentage change in volume	27.5	10.3	15.0	11.1	8.8	4.2	5.1	6.3
Imports goods	25.6	27.7	31.6	33.3	36.9	42.1	44.5	47.6
percentage change in volume	30.1	8.1	13.3	9.2	8.3	6.4	5.7	6.3
Services balance	1.2	0.9	1.1	1.5	0.6	1.3	1.4	1.5
of which: net travel	2.2	2.0	2.1	2.3	1.6	2.6	2.7	2.9
Net income	-1.8	-1.5	-1.4	-1.3	-1.6	-2.2	-2.2	-2.2
Net transfers	0.2	0.4	0.3	0.4	0.4	0.3	0.3	0.3
Capital account, net	0.2	0.0	0.3	0.3	0.2	0.2	0.2	0.2
Financial account, net	2.8	5.1	3.9	1.6	0.1	5.1	4.6	4.5
in percent of GDP	*6.0*	*10.7*	*8.3*	*3.0*	*0.2*	*6.3*	*5.2*	*4.8*
Net direct investment	1.6	1.7	1.2	2.3	0.6	1.6	1.7	2.1
Net portfolio investments	2.0	2.0	-0.4	1.5	1.6	3.0	2.4	2.0
Net other investments	-0.7	1.4	3.2	-2.2	-2.0	0.5	0.5	0.5
Errors and omissions	0.0	-0.4	-0.2	-0.2	0.5	0.0	0.0	0.0
Overall balance	0.8	2.3	1.1	-0.1	-1.8	1.5	0.7	0.6
Net reserves	-0.8	-2.3	-1.1	0.1	1.8	-1.5	-0.7	-0.6
Memorandum of items (end of period):								
Gross reserves	9.3	11.0	11.2	10.8	10.4	11.8	12.6	13.2
in months of goods and services imports	*3.7*	*4.1*	*3.7*	*3.3*	*2.8*	*2.9*	*2.9*	*2.8*
Gross foreign debt, in percent of GDP 2/	*55.6*	*64.2*	*64.3*	*64.9*	*55.3*	*47.5*	*46.9*	*44.5*
Net foreign debt, in percent of GDP 3/	*22.8*	*22.5*	*25.4*	*23.4*	*22.5*	*18.4*	*17.8*	*16.4*

Sources: National Bank of Hungary and staff estimates.

1/ These data reflect the methodological changes to the BOP statistics (described in the statistical issues appendix and the data ROSC update) that were introduced in late February 2003. Note that data on reinvested earnings are unavailable and therefore excluded for now from the official BOP statistics and the projections in this table. Incorporating these earnings, when the relevant data becomes available (expected in early 2004), would raise the current account deficit, and an offsetting entry would be made in the financial account leaving the overall balance of payments unchanged.

2/ Including intercompany loans.

3/ Foreign liabilities net of foreign assets, excluding equity but including intercompany loans.

Table 3a. Hungary: Consolidated General Government, 2000-2003 1/
(Official Account Basis)

	2000	2001	2002 Est.	2003 Budget
	(In billions of forint)			
Total revenues (ex. official privatization)	5,568	6,737	7,295	7,970
Interest and NBH receipts	123	70	59	50
Primary revenues	5,445	6,667	7,236	7,920
Central government taxes	4,704	5,303	5,858	6,528
VAT	1,154	1,244	1,305	1,587
Excises	506	540	591	640
Profit tax 2/	293	352	397	432
Customs	137	123	126	145
Personal income tax	938	1,117	1,275	1,376
Social security contributions 3/	1,677	1,928	2,166	2,348
Local government and other 4/	741	1,365	1,378	1,392
Expenditure and net-lending	6,048	7,181	8,911	8,813
Interest	801	657	677	694
Primary expenditure	5,247	6,524	8,235	8,119
Current	4,806	5,995	7,709	7,700
One-off 5/	0	0	603	0
Non one-off	4,806	5,995	7,106	7,700
Pensions and social transfers	1,448	1,750	1,905	2,269
Enterprise and household subsidies	548	655	743	796
Other current expenditure 6/	2,809	3,590	4,457	4,635
Capital 7/	441	528	526	419
Net interest	-678	-588	-618	-644
Primary balance	198	144	-998	-194
General Government Deficit	-480	-444	-1,616	-838
	(In percent of GDP)			
Total revenues	42.3	45.4	43.0	43.1
of which: primary revenues	41.3	44.9	42.6	42.9
Expenditure and net lending	45.9	48.4	52.5	47.7
Interest	6.1	4.4	4.0	3.8
Primary expenditure	39.8	43.9	48.5	43.9
Current	36.5	40.4	45.4	41.7
One-off 5/	0.0	0.0	3.6	0.0
Non one-off	36.5	40.4	41.8	41.7
Pensions and social transfers	11.0	11.8	11.2	12.3
Enterprise and household subsidies	4.2	4.4	4.4	4.3
Other current expenditure 6/	21.3	24.2	26.2	25.1
Capital 7/	3.3	3.6	3.1	2.3
Net interest	-5.2	-4.0	-3.6	-3.5
Primary balance	1.5	1.0	-5.9	-1.1
General government balance	-3.6	-3.0	-9.5	-4.5
Gross debt 8/	55.5	53.4	56.3	57.2

Sources: Ministry of Finance, National Bank of Hungary, and staff estimates.

1/ Official consolidated data for central budget, social security funds, extra-budgetary funds, and local governments (GFS basis).

2/ For 2003 onwards, includes the introduction of the simplified business tax.

3/ To the Pension Insurance Fund, the National Health Fund, and the Labor Market Fund.

4/ Includes privatization revenues of the social security funds and proceeds from the sale of concessions.

5/ Extraordinary expenditure on debt assumption and take over, recapitalization, purchase of shares and other one-off transactions.

6/ Include wages and salaries, and other goods and services of the general government, and investment not undertaken by the central and/or local government, for which a separate breakdown is not available.

7/ Central budget investment projects, local government capital expenditures, and housing grants.

8/ ESA-95 basis.

Table 3b. Hungary: Consolidated General Government, 2002-2003
(ESA-95 basis, in percent of GDP)

	2001	2002 Est.	2003 Budget
Revenues	45.4	43.0	43.2
Interest	0.5	0.3	0.3
Primary	45.0	42.7	42.9
Expenditure	50.1	52.2	47.7
Interest	5.3	4.1	3.9
Primary	44.8	48.1	43.8
Current	37.1	39.3	38.3
Capital 1/	7.7	8.7	5.5
Balance	-4.7	-9.2	-4.5

Source: Hungarian authorities and staff estimates.

1/ Estimates as of late 2002.

Table 4. Hungary: Staff Illustrative Medium-term Scenario 1/

	2000 Actual	2001 Actual	2002 Est.	2003	2004	2005
				Staff projections		
	(In percent, unless otherwise indicated)					
Real GDP growth	5.2	3.8	3.3	3.6	3.9	4.4
Nominal GDP, Forint billions	13,172	14,850	16,980	18,474	19,609	21,352
Inflation (CPI; end-year basis)	10.1	6.8	4.8	5.3	4.3	3.3
	(Annual percentage change, constant prices)					
Domestic Demand	4.5	1.7	5.3	4.5	4.2	4.5
Consumption	4.4	5.3	7.8	5.3	3.7	3.6
Gross fixed capital formation	7.6	3.5	5.8	2.2	5.7	7.1
Exports of GNFS	21.0	8.8	3.8	6.2	7.0	7.0
Imports of GNFS	19.4	6.0	6.1	7.1	7.3	7.0
	(In percent of GDP)					
External Current Account Deficit 2/	6.2	3.4	4.0	4.8	4.6	4.4
Gross Private Savings	21.9	23.1	23.3	22.4	21.0	20.9
Gross Private Investment	27.4	23.5	22.7	22.1	22.1	22.3
General Government						
Revenue, primary	41.3	44.9	42.6	42.9	42.3	41.5
Expenditure, primary	39.8	43.9	48.5	43.9	42.1	41.1
Primary balance	1.5	1.0	-5.9	-1.1	0.2	0.4
General Government Balance (ESA-95)	-3.0	-4.7	-9.2 3/	-4.5	-3.0	-2.5
Net interest	5.1	4.0	3.6	3.5	3.5	2.9
General Government Debt 4/	55.5	53.4	56.3	57.2	56.6	54.2

Source: IMF staff estimates.

1/ Incorporates staff's policy recommendations.

2/ The current account is not consistent with the concept of the use of foreign saving on a national accounts basis, which results in a statistical discrepancy in the data on the overall saving-investment balance. The reasons include the exclusion of reinvested earnings from the official statistics (an item which may vary over time, but for which official data are unavailable).

3/ The 2002 general government balance includes various one-off financial operations (amounting to 3.1 percent of GDP) that are not part of the saving-investment balance on a national accounts basis.

4/ ESA-95 basis.

Table 5. Hungary: External Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002 4/	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 External debt	54.8	55.6	64.2	64.3	64.9	55.3	47.5	46.9	44.5	42.8	41.8
2 Change in external debt	-8.4	0.8	8.6	0.1	0.6	-9.6	-7.8	-0.7	-2.3	-1.7	-1.0
3 Identified external debt-creating flows (4+8+11)	-5.0	-1.0	-5.9	2.1	-2.1	-8.1	-10.0	-2.0	-2.6	-2.1	-2.6
4 Current account deficit, excluding interest payments	-3.5	0.5	2.0	2.7	0.1	1.6	2.3	2.2	2.1	1.7	1.4
5 Deficit in balance of goods and services	-0.9	1.5	2.7	3.8	1.5	2.3	2.4	2.4	2.3	2.0	1.6
6 Exports	54.8	62.4	64.9	74.5	74.4	64.7	58.0	57.8	56.8	56.9	57.2
7 Imports	53.8	63.9	67.6	78.4	75.9	67.0	60.3	60.2	59.1	58.8	58.9
8 Net non-debt creating capital inflows (negative)	-5.5	-3.8	-9.5	-5.0	1.1	0.9	-4.8	-3.8	-3.1	-2.9	-3.3
9 Net foreign direct investment, equity	3.3	2.7	7.0	5.8	-1.3	-0.7	4.3	3.3	2.6	2.4	2.8
10 Net portfolio investment,equity	2.2	1.2	2.5	-0.9	0.3	-0.2	0.5	0.5	0.5	0.5	0.5
11 Automatic debt dynamics 1/	4.0	2.3	1.6	4.3	-3.2	-10.5	-7.5	-0.3	-1.5	-0.9	-0.7
12 Contribution from nominal interest rate	4.9	4.2	3.1	3.5	3.3	2.5	2.5	2.4	2.3	2.2	2.1
13 Contribution from real GDP growth	-2.9	-2.6	-2.3	-3.4	-2.2	-1.7	-1.6	-1.7	-1.9	-1.8	-1.8
14 Contribution from price and exchange rate changes 2/	1.9	0.7	0.8	4.3	-4.3	-11.3	-8.3	-1.0	-1.9	-1.2	-1.0
15 Residual, incl. change in gross foreign assets (2-3)	-3.4	1.9	14.5	-2.0	2.6	-1.5	2.2	1.3	0.2	0.4	1.6
External debt-to-exports ratio (in percent)	100.0	89.0	98.9	86.3	87.3	85.5	81.9	81.0	78.4	75.3	73.1
Gross external financing need (in billions of US dollars) 3/	11.6	11.4	10.1	11.2	11.0	12.8	13.6	14.3	15.5	13.0	11.5
in percent of GDP	25.4	24.2	21.0	23.9	21.2	19.5	16.6	16.5	16.4	12.8	10.6
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	4.6	4.9	4.2	5.2	3.8	3.3	3.6	3.9	4.4	4.4	4.4
Exchange rate appreciation (US dollar value of local currency, change in percent)	-18.3	-12.9	-9.6	-16.0	-1.5	11.1	14.4	0.0	0.0	0.0	0.0
GDP deflator in US dollars (change in percent)	-3.2	-1.9	-2.1	-7.7	6.9	23.0	20.1	2.2	4.3	2.8	2.3
Nominal external interest rate (in percent)	7.9	7.9	5.6	5.3	5.7	4.8	5.5	5.4	5.3	5.2	5.1
Growth of exports (US dollar terms, in percent)	30.7	17.3	6.0	11.5	10.8	10.5	11.5	5.9	7.0	7.5	7.5
Growth of imports (US dollar terms, in percent)	16.6	22.2	7.9	12.6	7.5	12.1	12.1	5.9	6.9	6.8	6.9
II. Stress Tests for External Debt Ratio											
Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows at historical avg. 2003-07						55.3	55.4	53.6	50.6	47.7	46.0
Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						55.3	49.2	50.4	47.9	46.1	45.1
Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						55.3	50.7	53.5	51.0	49.2	48.1
Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						55.3	64.0	72.4	69.3	67.1	65.7
Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						55.3	52.2	56.4	53.7	51.8	50.7
Combination of 2-5 using one standard deviation shocks						55.3	65.0	74.9	71.6	69.4	68.0
One time 30 percent nominal depreciation in 2003						55.3	73.3	72.4	69.2	67.1	65.7

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation
Current account deficit, excluding interest payments	0.5	3.3
Net non-debt creating capital inflows	5.0	3.2
Nominal interest rate (in percent)	7.0	1.1
Real GDP growth (in percent)	2.5	2.7
GDP deflator in US dollars (change in percent)	2.1	6.4

Sources: National Bank of Hungary, IFS, and staff estimates.

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).

3/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ Includes preliminary data as well as projections.

Table 6. Hungary: Public Sector Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 Public sector debt 1/	63.9	61.9	61.2	55.5	53.4	**56.3**	**57.2**	**56.6**	**54.2**	**52.2**	**48.8**
o/w foreign-currency denominated	26.0	25.2	23.9	20.6	18.7	21.6	20.0	19.6	18.8	18.3	17.4
2 Change in public sector debt	-7.7	-2.0	-0.6	-5.7	-2.1	2.9	0.9	-0.7	-2.4	-2.0	-3.3
3 Identified debt-creating flows (4+7+12)	0.4	-0.6	0.9	-2.1	-3.6	-0.7	0.0	-0.3	-2.1	-1.4	-1.2
4 Primary deficit	-5.4	-3.1	-3.8	-2.4	-1.4	5.5	0.8	-0.8	-0.9	-0.9	-0.9
5 Revenue and grants	44.9	43.5	43.2	42.3	45.4	43.0	43.1	42.9	42.0	41.5	41.0
6 Primary (noninterest) expenditure	39.6	40.4	39.4	39.8	43.9	48.5	43.9	42.1	41.1	40.6	40.1
7 Automatic debt dynamics 2/	2.8	-0.2	3.7	0.4	-2.2	-6.3	-0.8	0.5	-1.2	-0.5	-0.3
8 Contribution from interest rate/growth differential 3/	-3.6	-1.9	0.4	-2.2	-1.8	-2.7	-0.8	0.5	-1.2	-0.5	-0.3
9 Of which contribution from real interest rate	-1.0	0.7	2.7	0.6	0.0	-1.2	1.1	2.6	1.1	1.7	1.9
10 Of which contribution from real GDP growth	-2.6	-2.6	-2.3	-2.7	-1.9	-1.5	-1.9	-2.1	-2.3	-2.2	-2.1
11 Contribution from exchange rate depreciation 4/	6.5	1.7	3.3	2.6	-0.4	-3.6	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	3.0	2.7	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	3.0	0.9	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-8.1	-1.4	-1.6	-3.7	1.5	3.6	0.9	-0.4	-0.2	-0.7	-2.1
Public sector debt-to-revenue ratio 1/	142.1	142.3	141.6	131.4	117.7	131.1	132.7	131.8	128.9	125.8	119.1
Gross financing need 5/	5.5	5.5	4.5	4.4	3.8	10.3	5.3	3.8	3.3	3.1	2.9
in billions of U.S. dollars	2.5	2.6	2.2	2.1	1.9	6.8	4.3	3.3	3.1	3.1	3.1
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	4.6	4.9	4.2	5.2	3.8	3.3	3.6	3.9	4.4	4.4	4.4
Average nominal interest rate on public debt (in percent) 6/	17.6	14.6	13.8	11.5	9.0	8.5	7.3	7.0	6.6	6.4	6.2
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-0.9	2.0	5.4	1.6	0.4	-2.2	2.3	4.8	2.3	3.6	3.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	-19.0	-7.1	-13.3	-11.3	2.0	23.9	-0.1	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	18.5	12.6	8.4	9.9	8.6	10.7	5.0	2.2	4.3	2.8	2.3
Growth of real primary spending (deflated by GDP deflator, in percent)	7.9	7.0	1.8	6.3	14.5	14.0	-6.1	-0.4	1.9	2.9	3.2
II. Stress Tests for Public Debt Ratio											
Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						56.3	51.7	46.1	41.0	35.8	29.6
Real interest rate is at historical average plus two standard deviations in 2003 and 2004						56.3	61.1	63.2	60.7	58.6	55.3
Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						56.3	61.0	64.5	61.9	59.6	56.1
Primary balance is at historical average minus two standard deviations in 2003 and 2004						56.3	61.8	67.3	64.7	62.6	59.2
Combination of 2-4 using one standard deviation shocks						56.3	60.5	63.6	57.7	52.2	45.6
One time 30 percent real depreciation in 2003 7/						56.3	67.2	66.6	64.0	61.9	58.5
10 percent of GDP increase in other debt-creating flows in 2003						56.3	67.2	66.7	64.1	61.9	58.6

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2002-07
Primary deficit	-1.6	3.5	0.5
Real GDP growth (in percent)	2.5	2.7	4.0
Nominal interest rate (in percent) 6/	11.8	3.2	7.0
Real interest rate (in percent)	-4.9	7.3	2.4
Inflation rate (GDP deflator, in percent)	16.7	6.2	4.5
Revenue to GDP ratio	44.2	1.4	42.3

Source: Hungarian authorities, and staff estimates.

1/ Consolidated general government, gross debt, ESA-95 basis.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 7. Hungary: Frequently Used Indicators of Stability and Vulnerability in the Financial and External Sectors
(Year end, in percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	Date of latest Observation
Financial Indicators						
Public sector debt	60.0	55.3	52.3	52.5	...	Q3, 2002
Broad money (M3, percent change, 12-month basis)	13.1	18.1	17.1	9.5	14.2	Feb '03
Private sector credit (percent change, 12-month basis)	21.5	34.8	18.2	22.2	22.7	Feb '03
Credit to non-financial corporations	17.7	30.5	9.5	6.1	5.5	Feb '03
Credit to households	36.2	47.4	46.4	68.4	67.1	Feb '03
Domestic credit (percent change, 12-month basis)	-5.1	16.1	3.1	23.7	23.6	Feb '03
3-month T-bill yield	12.4	11.6	9.7	7.9	6.1	Feb '03
3-month T-bill yield (real) 1/	1.6	1.3	3.1	3.2	1.3	Feb '03
Non-performing loans as a percent of total loans 2/ 3/	4.2	3.0	2.7	3.0	...	Dec '02
Capital adequacy ratio (in percent) 3/	14.2	13.7	13.9	11.1	...	Dec '02
Foreign exchange loans as a percent of total loans	...	33.2	29.3	29.0	30.6	Jan '03
External Indicators						
Exports of goods & services (percent change, 12-month basis in US dollars) 4/	6.0	11.5	10.8	10.5	...	
Imports of goods & services (percent change, 12-month basis in US dollars) 4/	7.9	12.6	7.5	12.1	...	
Terms of trade (percent change, 12-month basis)	0.6	-2.7	2.5	0.4	...	Q1-3, 2002
Current account balance 4/	-5.1	-6.2	-3.4	-4.1	...	
Capital and financial account balance 4/	10.7	8.9	3.6	0.5	...	
Of which: Inward portfolio investment (debt securities etc.)	2.5	-1.9	2.1	-0.4	...	
Other investment (loans, trade credits etc.)	3.0	6.8	-4.2	-3.2	...	
Inward foreign direct investment (other than equity)	0.6	0.6	3.1	-0.6	...	
Net foreign assets (NFA) of commercial banks (in billions of US dollars)	0.6	0.2	2.2	1.8	...	Nov '02
Gross official reserves (in billions of US dollars)	11.0	11.2	10.8	10.4	14.0	Feb '03
Central bank foreign currency exposure (in billions of US dollars) 5/	5.6	7.2	-7.5	-7.5	...	
Official reserves in months of imports of goods and services 6/	4.1	3.7	3.3	2.8	3.8	Feb '03
Ratio of reserve money to official reserves	0.9	0.7	0.7	1.0	0.9	Jan '03
Ratio of broad money to official reserves	1.9	1.8	2.4	3.3	2.2	Jan '03
Ratio of total short-term external debt to net official reserves 7/	1.1	1.1	0.9	0.7	...	2002 Q4
Total external debt 8/	64.5	66.8	64.3	57.2	...	
Of which: Public sector debt	38.1	32.0	28.8	26.3	...	
Total external debt 9/	58.0	59.9	55.4	47.8	...	
Total external debt as a percent of exports of goods & services 9/	84.7	79.5	74.7	79.7	...	
Total external debt service as a percent of exports of goods & services 10/	16.6	14.3	13.0	12.6	...	
Exchange rate (per US$, period average)	237.1	282.2	286.5	257.9	227.5	Feb '03
REER depreciation (-) (12 month basis; CPI-based)	1.7	0.6	8.0	10.8	...	
Financial Market Indicators						
Stock market index (end of period)	10,101	7,850	7,131	7798	7,397	19-Mar-03
Foreign currency debt rating (Moody's)	Baa1	A3	A3	A1	A1	19-Mar-03
Spread of dollar-denominated benchmark bond (basis points, end of period) 11/	107.0	116.0	78.0	59.5	57.6	19-Mar-03
Spread of DM-denominated benchmark bond (basis points, end of period) 12/	...	53.0	41.0	55.7	30.6	19-Mar-03

Sources: National Bank of Hungary, Ministry of Finance, Bloomberg, and staff estimates.

1/ Backward-looking using actual CPI.
2/ Comprised of loans classified as substandard, doubtful, and bad.
3/ Excludes the Hungarian Development Bank and the Eximbank.
4/ These data reflect the methodological changes to the BOP statistics (described in the statistical issues appendix and the data ROSC update) that were introduced in late February 2003.
5/ Net foreign assets plus foreign exchange credit to the government and banks less foreign exchange deposits of banks.
6/ Data for 2003 are expressed in terms of imports in 2002.
7/ Includes short-term loans (by remaining maturity), and nonresident holdings of domestic bonds. Official reserves are net of resident foreign exchange deposits with the National Bank.
8/ Including intercompany loans.
9/ Excluding intercompany loans.
10/ Medium-term credit amortization and gross interest expenditures, denominated in foreign currencies, excluding intercompany loans.
11/ NBH bond maturing April 2003 (US$-denominated) and a U.S. government bond with similar maturity.
12/ NBH bond maturing September 2003 (DM-denominated) and a German government bond with similar maturity.

Table 8. Hungary: Monetary Survey, 2001-2002
(In Billions of Forint, at Current Exchange Rates, End-of-Period)

	2001				2002			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Domestic claims	7,149	6,836	7,313	7,492	7,709	8,133	8,465	9,114
Claims on non-financial corporations	3,509	3,495	3,690	3,740	3,840	3,949	4,131	3,874
Of which:								
Credits	3,318	3,284	3,447	3,487	3,557	3,675	3,835	3,698
Forint	2,067	2,129	2,226	2,327	2,361	2,454	2,547	2,487
Foreign currency	1,251	1,156	1,212	1,160	1,196	1,220	1,289	1,211
Claims on other financial corporations	263	338	368	401	443	522	581	655
Of which:								
Credits	217	295	326	357	400	479	540	602
Forint	116	153	147	155	151	160	174	173
Foreign currency	94	130	177	201	246	316	365	427
Consolidated Central Government	2,682	2,225	2,396	2,392	2,411	2,481	2,355	2,989
Local governments	53	59	59	72	73	84	87	116
Households	634	713	794	871	932	1,085	1,298	1,467
Forint	622	698	776	850	906	1,055	1,263	1,431
Foreign currency	12	15	18	22	26	30	34	36
Non-profit institutions	7	6	6	15	11	12	13	13
Net foreign assets	231	478	647	873	651	433	421	512
Broad money (M3)	6,209	6,352	6,672	7,172	6,815	6,943	7,142	7,856
M2	5,628	5,731	6,111	6,631	6,465	6,702	6,867	7,544
Currency outside monetary institutions	838	903	957	1,038	1,005	1,101	1,149	1,182
Households	765	824	874	952	921	1,007	1,052	1,088
Other	74	79	84	86	84	94	98	94
Deposits	4,789	4,827	5,154	5,594	5,460	5,601	5,718	6,362
of which:								
Non-financial corporations	1,464	1,512	1,576	1,771	1,652	1,840	1,827	2,110
Forint	1,165	1,211	1,269	1,412	1,319	1,452	1,453	1,714
Foreign currency	300	301	307	359	333	388	375	396
Households	3,014	3,041	3,151	3,419	3,416	3,429	3,498	3,752
Forint	2,247	2,325	2,415	2,654	2,691	2,751	2,834	3,125
Foreign currency	767	716	736	765	725	678	665	627
Sale and repurchase agreements	29	51	39	21	39	27	97	109
Securities issues by monetary financial institutions with maturity up to 2 years	464	476	424	400	161	58	28	19
Money market funds shares/units	89	95	98	120	150	155	150	183
Liabilities with maturity over 2 years	328	346	356	379	414	413	461	668
Other claims net	-842	-616	-932	-813	-1,130	-1,210	-1,282	-1,101
Memorandum Item:								
Domestic Credit	6,911	6,582	7,028	7,194	7,383	7,815	8,128	8,885

Source: National Bank of Hungary's Monetary Survey.

HUNGARY: FUND RELATIONS
(As of February 28, 2003)

I. **Membership Status**: Hungary became a member of the Fund on May 6, 1982; Article VIII.

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	1,038.40	100.0
Fund holdings of currency	603.52	58.12
Reserve position in Fund	434.89	41.88
Financial Transaction Plan transfers (net)	11.00	

III. **SDR Department**:

	SDR Million	Allocation
Holdings	25.97	N/A

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	3/15/96	2/14/98	264.18	0.0
Stand-by	9/15/93	12/14/94	340.00	56.70
EFF	2/20/91	9/15/93	1,114.00	557.24

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

Between May 16, 1994 and January 1, 1997, the exchange rate of the forint was linked to a basket of the European Currency Unit (with a weight of 70 percent) and the U.S. dollar (with a weight of 30 percent). On January 1, 1997, the NBH changed the composition of its fixing basket to a combination of deutsche mark (with a weight of 70 percent) and the U.S. dollar (with a weight of 30 percent). Since January 1, 1997, the NBH has based its official rate on the interbank spot rates. Margins for the NBH's intervention band were widened to ±2.25 percent on December 23, 1994; and ±15 percent on May 4, 2001. Until March 13, 1995, the value of the peg to the basket was adjusted periodically, mainly on the basis of the difference between domestic and foreign inflation rates; from then until October 1, 2001, the value of the peg was adjusted in accordance with a preannounced rate of crawl. Since October 1, 2001, the central parity has been set at 276.1 forint per euro. Between March 13 and June 30, 1995, the rate of devaluation against the basket was 1.9 percent per month; it was reduced to 1.3 percent per month as of July 1, 1995; to 1.2 percent per month as of January 1, 1996; to 1.1 percent per month from April 1, 1997; to 1.0 percent per month as of August 15, 1997; to 0.9 percent per month from January 1, 1998, to 0.8 percent per month from June 15, 1998; to 0.7 percent per month from October 1, 1998; to 0.6 percent per month from January 1, 1999; to 0.5 percent per month from July 1, 1999; to 0.4 percent per month from October 1, 1999; to 0.3 percent as of April 1, 2000; to 0.2 percent as of April 1, 2001; and eliminated effective October 1, 2001. As of January 1, 2000, the central parity of the intervention band has been defined solely in terms of the euro.

Hungary accepted the obligations of Article VIII as of January 1, 1996, and its exchange system is free of restrictions on payments and transfers of current international transactions. In accordance with UN Resolution 661 and Executive Board decision No.144–(52/51), Hungary continues to maintain exchange restrictions against Iraq. The UN Security Council Resolution on food for oil was implemented in December 1996.

VIII. **Article IV Consultations**:

Hungary is on a 12-month consultation cycle.

The 2002 Article IV staff report was issued on April 30, 2002 (SM/02/128). The last Article IV Board discussion took place on May 22, 2002. The Public Information Notice No. 02/58 was released on June 5, 2002.

IX. **Technical Assistance:**

Year	**Dept.**	**Purpose**	**Date**
1991	FAD	Tax reform	April
1991	EU1/IMF Institute	Seminar on financial programming	May
1991	FAD	Budget reform	May
1991	FAD	Tax administration reform	June
1991	MAE/PDR	Development of a foreign exchange interbank market	September
1991	MAE/PDR	Development of a foreign exchange	October

		interbank market	
1991	FAD	Budget reform	November
1991	FAD	Tax administration reform	November
1992	STA	Money and banking statistics seminar	March
1992	FAD	Design and implementation of a "flash" fiscal reporting system	May
1992	FAD	Revenue forecasting	June
1993	MAE/EU1/IBRD	Financial and enterprise restructuring	March
1993	MAE	Central bank reorganization	May
1994	FAD/EU1	Treasury/debt management	February
1994	FAD	Tax administration	March
1994	STA/PDR	International trade and balance of payments statistics	April
1994	FAD	Tax administration follow-up	May
1994	FAD	Expenditure management	June
1994	FAD	Tax administration long-term expert assignment (on-going)	July
1994	FAD	Local government	August
1994	FAD	Tax administration	November
1995	FAD	Tax administration	February
1995	FAD	Treasury	February
1995	FAD	Treasury	May
1995	FAD	Treasury	November
1995	FAD	Debt management	November
1995	MAE	Central bank internal auditing	November
1995	MAE	Monetary analysis and research	December
1996	FAD	Tax policy	May
1996	MAE	Central bank accounts	September
1996	FAD	Subsidies	November
1997	FAD	Subsidies follow-up	May
2000	FAD	Tax legislation	June
2000	MAE	Money and banking statistics	October
2000	FAD	Tax legislation follow-up	November
2002	FAD	Expenditure rationalization	November

X. **Regional Resident Representative:**

The regional office was closed in July 2002.

HUNGARY—STATISTICAL ISSUES

1. Significant progress has been made in improving the coverage, periodicity, and quality of Hungarian statistics. Most data quality issues noted in the data dissemination module of the 2001 Report on the Observance of Standards and Codes and its 2002 update have been satisfactorily addressed, but some shortcomings still remain.[1]

2. Hungary has subscribed to the Special Data Dissemination Standard, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (http://dsbb.imf.org). Hungary meets the SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars.

A. Real Sector Issues

National accounts

3. A statistical discrepancy between the final version of GDP by production activities and GDP by expenditure components appeared in 1997, and persisted in subsequent years. From 2000, the Hungarian Central Statistical Office (HCSO) has been regularly publishing an estimate of this discrepancy. From June 2002, the HCSO also publishes seasonally-adjusted estimates of quarterly GDP by type of economic activity and by expenditure components beginning with the first quarter of 1995. The benchmarking of the quarterly estimates to the annual estimates has been applied from 2000. Estimates of imputed owner-occupied rent, which are currently based on 1993 benchmarks, are undergoing revision in line with the recommendations of the Eurostat.

B. Balance of Payments

5. A work plan, with clear time tables, is being implemented to substitute, by 2004, the current cash-based balance of payments statistics, compiled by the Magyar Nemzeti Bank (MNB), with the accrual-based accounting principles of the fifth edition of IMF's *Balance of Payments Manual (BPM5)*. In February 2003, trade data recorded on settlement basis were replaced by customs data beginning with the 2002 annual data. Consistent with the use of customs data, goods under processing and repair, as of February 2003, are being treated in the BOP as goods rather than services. Financial lease arrangements will reflect an imputed change of ownership and transactions will be classified according to the BPM5 methodology. Moreover, in 2004, estimates of reinvested earnings will be included in the balance of payments statistics, raising the current account deficit with an offsetting impact on the

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[1] For more detail see Hungary: Report on the Observance of Standards and Codes—Data Module, 2003 Update (forthcoming) and Hungary: Report on the Observance of Standards and Codes—Fiscal Module, 2003 Update (forthcoming).

financial accounts. Also in 2004, investment income will be recorded on an accrual basis, thus placing the entire balance of payments statistics on accrual accounting.

6. In 2002, the MNB and the HCSO reconciled their data sources and methodologies with regard to travel receipts and payments, thus eliminating a discrepancy which had existed in this area between the balance of payments statistics and the national income accounts.

7. The cooperation between the HCSO and the MNB has been strengthened as the two institutions entered into a formal agreement to improve statistics and harmonize data sources in a number of areas, including travel noted earlier.

C. Monetary Sector

8. The *IFS* country page for Hungary now provides timely data for the monetary authorities, banking institutions, and the banking survey. In addition, the coverage of the MNB's analytical accounts has been extended, and Hungary now complies with the strengthened reserves standard. STA conducted a money and banking statistics mission in October 2000 to review progress in this area and to discuss recent methodological changes in the compilation of monetary statistics. The STA mission found that the framework for the compilation of monetary statistics in Hungary basically conforms to the Fund's current methodology. A ROSC data module mission in January 2001 suggested excluding deposit liabilities of credit institutions under liquidation (currently, there are three such institutions) from the monetary aggregates by reclassifying them as "restricted deposits." The MNB has decided, as from beginning 2003, that these credit institutions are no longer classified as Monetary Financial Institutions (depository corporations) and hence deposits held with these institutions are excluded from the monetary aggregates. The deposits of these credit institutions held with the MNB and with other credit institutions have been reclassified as deposits of "nonfinancial enterprises," thus excluding them from base money. STA had also recommended basing the assets and liabilities of depository corporations on market valuation. Securities on the balance sheets of depository corporations are currently based on partial market valuation. The MNB intends to move to full market pricing of securities once the national accounting system adopts market valuation and once market information on security prices improves. Other balance sheet items are already in conformity with ECB guidelines: credit extended is on a gross basis (excluding interest accrued); fixed assets are at acquisition cost; deposits are at face value (without interest accrued); and debt securities not reported at market value are recorded at face value and zero coupon bonds at discounted value.

Starting with the release of data for January 2003, the MNB has been compiling and publishing the monetary aggregates by adopting a new methodology consistent with that used by the European Central Bank. In addition to the central bank and credit institutions, monetary financial institutions now also comprise money market funds (MMFs), as the investment units issued by MMFs show characteristics similar to those of bank deposits. Accordingly, the MMFs' balance sheet data are included in the consolidated balance sheet of the banking system (depository corporations survey).

D. Government Finance Statistics

9. The degree of decentralization of fiscal institutions hinders the full consolidation of government accounts, thereby leading to lags in availability of the data, and complications in estimating the national accounts.

10. Significant progress was made in addressing several of these issues with the establishment and subsequent expansion of the centralized Treasury and improved compilation of statistics at the Ministry of Finance. However, plans to report monthly expenditures classified on an economic basis have yet to come to fruition. Following a GFS mission in 1998, the authorities provided annual data for publication in the *GFS* Yearbook starting from 1991. The latest data published in the *GFS* Yearbook are for the year 2000. These data now cover the operations of the State Property Management and Privatization Company, since its inception in 1995. Moreover, progress was made in 2002 in widening the coverage of the general government budget and eliminating some important quasi-activities of government institutions, notably those of the Hungarian Development Bank. The GFS Yearbook data, and the monthly data reported for *IFS,* still contain inconsistencies between the measures of the deficit and financing. The *GFS Yearbook* data contain significant adjustments to current expenditure in order to balance the deficit and financing.

Hungary: Core Statistical Indicators

(As of March 31, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	External Debt/ Debt Service	Consolidated Government Balance	GDP
Date of Latest Observation	31-Mar	28-Feb	28-Feb	28-Feb	28-Feb	28-Feb	28-Feb	31-Jan	31-Jan	31-Jan	28-Feb	2002 Q4
Date Received	31-Mar	7-Mar	10-Mar	31-Mar	31-Mar	27-Mar	17-Mar	14-Mar	14-Mar	14-Mar	24-Mar	25-Feb
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of Update	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	Central Statistical Office of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	Ministry of Finance	Central Statistical Office of Hungary
Mode of Reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Email
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly

HUNGARY— RELATIONS WITH THE WORLD BANK GROUP

1. Hungary joined the World Bank in 1982. Since then the Bank has committed some US$4.3 billion for 40 projects and programs. During the 1980s, Bank assistance focused on liberalizing the economy and modernizing and expanding its productive capacity, and infrastructure. During the 1990s, support for macroeconomic and structural adjustment became a key element of the assistance program, including structural adjustment loans in the early 1990s, accompanied by Japan Exim co-financing and an IMF EFF Program, and sector adjustment loans in the mid-1990s supporting financial sector and pension reform. The Bank also provided support to help strengthen public institutions (e.g., in tax administration and public finance, health and social assistance).

2. Since the Country Assistance Strategy discussed by the Bank's Board on January 28, 1998, Hungary has continued to establish a sustainable and robust macroeconomic environment, complete the transformation agenda, and makes progress towards meeting the requirements for EU accession and is now expected to joint the union by 2004.

3. Hungary continues to enjoy access to private capital at terms that are extremely competitive for sovereign borrowings, and to significant financing from European institutions. Consequently, Hungary has ceased to borrow from the World Bank and does not envisage any further borrowing. The consensus view across the political spectrum is that the country would like to initiate the graduation process. A fairly recent CAS Progress Report, discussed by the Bank's Board on April 2002; envisages a pre-graduation assistance program limited to analytical and advisory services, oriented to complement the support available from the EU and other sources, taking into account institutional comparative advantages.

4. There is only one ongoing Bank-financed projects, the Municipal Wastewater Management with an undisbursed balance of about US$13 million as of March 1, 2003. With nearly negligible borrowing from the Bank in recent years, Hungry has started to cancel portions of undisbursed loans, and has started to pre-pay some loans. Hungary's outstanding obligations to the Bank amount to about US$0.5 billion as of March 1, 2003. IFC have not undertaken new investments and guarantees in Hungary in recent years.

INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the 2003 Article IV Consultation
Supplementary Information

Prepared by the European I Department

Approved by Carlo Cottarelli

April 30, 2003

1. This statement reviews developments in Hungary since the preparation of the staff report for the 2003 Article IV consultation and highlights the authorities' recent actions related to the HIPC (Highly Indebted Poor Countries) initiative. The additional information does not change the thrust of the staff appraisal. A referendum on EU accession was held on April 12. With a turnout of about 45½ percent, almost 84 percent of the votes were in favor of accession.

Recent Economic Developments and Data Revisions

2. Recent economic developments include:

- Merchandise exports (in euro terms) in January-February 2003 were 5.2 percent lower than a year ago. With import growth not as weak, the 12-month external current account deficit widened to 4.2 percent of GDP in February, compared with 4.0 percent in December 2002. Manufacturing output was affected by the weakness of exports: on a year-on-year basis, it was up only 2 percent in January-February 2003.

- Total employment in January-February 2003 was up one-half of a percent on a year ago, on account of a 4 percent rise in public employment; private sector employment decreased 1.1 percent in the same period. With the growth of the labor force outstripping that of total employment, the average unemployment rate rose to 6.4 percent in the first quarter of this year from 5.8 percent in the first quarter of 2002.

- Headline CPI inflation rose to 4.7 percent, year-on-year, in March from 4.5 percent in February. However, core inflation (which excludes food and fuel) dropped slightly to 4.8 percent.

- Gross monthly wage growth in the private sector was 9.8 percent, year-on-year, in January-February 2003 (compared with year-average growth of 13.3 percent in 2002).

Public sector wage growth was 30.9 percent in January-February 2003 (compared with 29.2 percent in 2002).

- Notwithstanding sizable foreign borrowing by the government, foreign exchange reserves of the Magyar Nemzeti Bank (MNB) dropped by about €1.6 billion in February and March 2003. This is consistent with the continued sales of foreign exchange to mop up liquidity and help to unwind long forint positions in the wake of the speculative attack.

- The MNB has informed staff that it now projects a widening of the external current account deficit (using the new BOP methodology) of about one percentage point of GDP in 2003 compared with the preceding year.

- Based on preliminary data, the general government deficit was around 1½ percent of GDP in the first quarter, compared to a similar ratio in the first quarter of 2002. Total revenues of the consolidated general government increased by 13.7 percent on a year-on-year basis in the first quarter, while total expenditures increased by 14 percent year-on-year. As noted by the authorities, comparing the data so far for 2003 with data for the same period of 2002 requires a note of caution, including in light of the introduction in the second half of that year of several measures raising wages, pensions, and social transfers, and reducing personal income taxes. The Finance Ministry has indicated that the data for the first quarter of 2003 are in line with their monthly projections, consistent with the whole year fiscal target. Staff broadly agrees that the target is still achievable, but sees risks for the remainder of the year, consistent with the staff report.

- The authorities have informed staff that the current estimate of the size of privatization receipts this year is equivalent to 1 percent of GDP (compared with 1½ percent of GDP reported in paragraph 25 of the staff report).

- In early April, parliament passed an anti-corruption legislative package known as the "glass pocket law," which aims to make the use of public funds more transparent.

- With respect to Appendix II, paragraph 3 of the staff report, the authorities have informed the staff that revisions to imputed owner-occupied rent have been carried out.

3. Data revisions include:

- Since the staff report was issued, the Hungarian Central Statistics Office (HCSO) released figures for nominal GDP in 2002 and modified the figures for 2000 and 2001 due to methodological changes. This data would modify several of the ratios used in the tables and text, but only slightly, and not in a way that would modify the analysis and conclusions of the staff report. For example, the ratio of the external current account deficit to GDP in 2002 would be 4 percent rather than 4.1 percent, whereas the ratio of the general government deficit (on ESA-95 basis) to GDP in 2002 would be 9.2 percent rather than 9.5 percent

- The HCSO also released figures for the components of real GDP in the fourth quarter of 2002 and revised some of the data on the components of real GDP for recent years. The new figures are shown in the attached Table. While paragraph 5 of the staff report indicates that export volume growth actually may have turned negative in the fourth quarter, the new data indicate that the volume of exports was 1.2 percent higher than a year ago. However, the HCSO made downward revisions to (real) export growth during the first three quarters of 2002. While import growth was revised downward by roughly a similar amount, so that the contribution of net trade to GDP was not affected significantly, the revisions would suggest that, in the face of subdued demand from the EU, the export sector has held up less well than previously thought. For the year as a whole, real export growth was 3.8 percent (compared with a previous estimate, based on the unrevised data, that was around two percentage points higher).

- The Ministry of Finance revised the data for general government debt on an ESA-95 basis. While this increased the debt at end-2001 and end-2002 by up to 1.4 percentage point of GDP, the effect on the debt to GDP ratio in 2002 was more than offset by the upward revision to nominal GDP.

HIPC

4. In the context of the HIPC initiative, the Hungarian authorities have agreed to provide debt relief on all of its claims on Ethiopia, Mozambique, Nicaragua and Tanzania. The authorities started negotiations with Ethiopia in November 2002. They are currently formulating their approach concerning the claim on Mozambique, and are waiting for a response from Nicaragua on an offer made in April of this year. Finally, the Hungarian authorities initiated a meeting between the Tanzanian authorities and General Electric (the holder of the relevant claim after the original holder Tungsram—which was a state-owned manufacturer of electrical equipment—was privatized).

Table. Hungary: Revised National Accounts Figures and Selected Ratios

	2000 Actual	2001 Actual	2002 Est.
	(In percent, unless otherwise indicated)		
Real GDP growth	5.2	3.8	3.3
Nominal GDP, Forint billions	13,172	14,850	16,980
	(Annual percentage change, constant prices)		
Domestic Demand	4.5	1.7	5.3
Consumption	4.4	5.3	7.8
Gross fixed capital formation	7.6	3.5	5.8
Exports of GNFS	21.0	8.8	3.8
Imports of GNFS	19.4	6.0	6.1
	(In percent of GDP)		
External Current Account Deficit 1/	6.2	3.4	4.0
Gross Private Savings	21.9	23.1	23.3
Gross Private Investment	27.4	23.5	22.7
General Government			
Revenue, primary	41.3	44.9	42.6
Expenditure, primary	39.8	43.9	48.5
Primary balance	1.5	1.0	-5.9
General Government Balance (ESA-95)	-3.0	-4.7	-9.2 2/
Net interest	5.1	4.0	3.6
General Government Debt 3/	55.5	53.4	56.3

Source: IMF staff estimates.

1/ The current account is not consistent with the concept of the use of foreign saving on a national accounts basis, which results in a statistical discrepancy in the data on the overall saving-investment balance. The reasons include the exclusion of reinvested earnings from the official statistics (an item which may vary over time, but for which official data are unavailable).
2/ The 2002 general government balance includes various one-off financial operations (amounting to 3.1 percent of GDP) that are not part of the saving-investment balance on a national accounts basis.
3/ ESA-95 basis.

Public Information Notice (PIN) No. 03/58
FOR IMMEDIATE RELEASE
May 9, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Hungary

On May 2, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Hungary.[1]

Background

Reflecting a remarkably successful transition, Hungary is now on the verge of European Union membership. Strong external competitiveness, export growth, and foreign direct investment (FDI) have been at the heart of Hungary's success. This success has also been backed by careful macroeconomic management and significant structural reforms. However, with elections in 2002, fiscal policy was highly politically-charged and turned very expansionary, contributing to macroeconomic imbalances and an inordinate burden on monetary policy.

Developments in growth and inflation were broadly positive in 2002. Buoyed by domestic demand, real GDP growth increased to 3.5 percent (year-on-year) in the second half of this year from 3.0 percent in the first half. Headline inflation declined from its recent peak of 10.8 percent in May of 2001 (when the exchange rate band was widened) to 4.8 percent at end-2002 (and 4.5 percent at end-February 2003). Core inflation also declined significantly, and the central bank has essentially met two consecutive year-end inflation targets.

However, recent wage growth has been extremely rapid. On an economy-wide basis, year-average wage growth was 18.3 percent in 2002. This reflected continued strong wage growth in the private sector on the back of a 25 percent hike in the minimum wage early in 2002, which not only increased wages on its own but also compressed the wage scale leading

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during Executive Board discussion based on the staff report.

to further upward wage pressure. Rapid wage growth in the public sector also reflected the 50 percent wage increase in September for some three-quarters of the public work force (without any reform of public employment). The carryover effect of the public wage increase is significant, while the demonstration effect on private wages could also be considerable.

Reflecting both wage increases and nominal exchange rate appreciation, external competitiveness declined significantly during 2001–02. The Unit Labor Costs-based real effective exchange rate appreciated by some 20 percent during this period, reflecting both exchange rate appreciation and, to a greater extent, rising relative unit labor costs. The resulting loss of external competitiveness dampens export performance now and with a lag, and may also be adversely affecting FDI. Moreover, the loss of competitiveness would raise even more serious concerns about export prospects and FDI if rapid wage growth were to persist.

The external current account deficit widened in 2002 while FDI fell off sharply. Thus, the deficit was mostly financed by debt and a decrease in official reserves. Buoyed by real appreciation, wage increases, and a fiscally-induced strengthening of domestic demand, import growth was strong. At the same time, tourism receipts fell sharply. This resulted in a current account deficit of 4.1 percent of GDP, compared with 3.4 percent in 2001. The year-on-year growth of exports of goods and services slowed down considerably in the second half of the year. The deficit would perhaps be some 2–3 percent of GDP larger if data on reinvested earnings were available and included in the official statistics.

By any standard, fiscal policy was highly expansionary in 2002. Compared with deficits (on an European System of Accounts-95 basis) of 3.0 percent of GDP in 2000 and 4.7 percent of GDP in 2001, the estimated deficit of the general government reached 9.5 percent of GDP. While one-off expenditures were sizable and their fading out will lower the fiscal deficit in 2003, there were significant permanent expenditure increases—notably on wages and pensions, as well as on health-related spending, social benefits, and subsidies. These increases not only added to the deficit last year, but they will also complicate fiscal consolidation efforts in this and later years.

Fiscal laxity, alongside rapid wage increases, put monetary policy in a difficult bind. With upside risks to inflation predominating, a speculative attack against the strong edge of the exchange rate band in January brought to a head the conflict between inflation and external objectives—in the face of a widening current account deficit and concerns over the external competitiveness. To fend off the attack, the central bank cut interest rates, undertook major foreign exchange intervention, and limited access to its two-week deposit facility. With the inflation target subordinated to exchange rate considerations in the near term, the central bank's scope to affect the inflation outturn in 2003 is limited, and inflation is likely to exceed its end-2003 target of 3½ percent ± 1 percent.

Executive Board Assessment

Executive Directors commended the Hungarian authorities for their track record of far-reaching institutional and structural reforms, and their successes in macroeconomic management. Hungary has almost completely emerged from the transition from a planned to a market-based economy, and has become highly integrated with the EU. Thus, if supported by the necessary vigorous fiscal adjustment, wage restraint, and continued structural reform, this integration will provide a good basis for progress in the direction of the adoption of the euro. Directors welcomed in this regard the strongly positive outcome of the national referendum on Hungary's accession to the EU, and Hungary's signature of the Accession Treaty in Athens.

Notwithstanding these economic achievements, Directors were concerned that a drastic increase in wages in excess of productivity growth, and an expansionary fiscal policy had contributed to weakening Hungary's external competitiveness and widening the current account deficit. They also observed that the authorities' inflation target for 2003 is at risk, making it even more important to ensure that the target for 2004 is met.

Directors observed that the speculative attack in January 2003 against the upper end of the exchange rate band of the forint highlighted the conflict between the authorities' inflation and external objectives, and clearly pointed to the need to adjust the policy mix by shifting the focus to fiscal consolidation and wage moderation. They emphasized that, notwithstanding the market's recent exuberance about Hungary's accession to the EU, market expectations can change unexpectedly, and avoiding sizable fiscal and current account deficits would help sustain market confidence. These considerations reinforce the need for vigorous fiscal consolidation at an early juncture and into the medium term.

Directors encouraged the authorities to press ahead with the bulk of fiscal adjustment in 2003-04—ahead of the next election cycle. They supported the authorities' fiscal deficit targets, and emphasized the need for corrective actions if slippages occur. To secure durable fiscal adjustment and satisfactory economic growth, fiscal consolidation in 2004 should focus on structural elements aimed at restraining current expenditure, including in the areas of public employment, health care, pensions, social benefits, and subsidies. A number of Directors pointed to the advisability of safeguarding capital investment given the need to develop Hungary's infrastructure in the context of coming EU accession. In light of the magnitude of the fiscal adjustment required, a few Directors recommended considering the postponement of the envisaged tax reductions.

Given the importance of expenditure restraint for meeting fiscal deficit targets, Directors welcomed the authorities' intention to introduce three-year rolling fiscal frameworks with expenditure ceilings. They recommended that the ceilings be submitted to parliament for approval along with the budget and a supporting policy statement, and urged the authorities to adopt subceilings on key expenditure areas where restraint is especially needed.

Directors saw wage moderation as a key component of further disinflation and external competitiveness, especially in light of the significant wage increases granted last year. They urged the authorities to signal the importance they now attach to wage moderation by implementing the planned public sector wage freeze this year strictly, and by keeping public sector wage increases below the inflation target next year. Directors observed at the same time that greater emphasis might be placed on reducing the number of noncritical public employees. A few Directors considered that an undifferentiated wage containment could risk the exit of highly skilled and valuable workers from public service. Pointing to the positive experience of some current members of the euro area, and while emphasizing the value of preserving the traditional flexibility of the Hungarian labor market, Directors highlighted the benefits of closer cooperation between the social partners, with a view to achieving wage agreements that would help to bring inflation down to the Maastricht criterion level in due course. Directors recommended that wage guidelines be set in nominal rather than real terms, for simplicity and to discourage backward-looking indexation.

On monetary policy, Directors considered that the central bank had responded appropriately to difficult challenges. At the same time, Directors were concerned that the credibility of the inflation targeting framework had been weakened by its subordination to exchange rate considerations in the near term. However, Directors viewed the end-2004 inflation target as achievable, and welcomed the authorities' focus on the necessary supporting policies. Nevertheless, they cautioned that deviating from a tight incomes policy and the envisaged fiscal deficit path would clearly make it difficult to meet the inflation objectives without compromising external competitiveness.

In considering more specifically Hungary's plans for joining the European Monetary Union and while recognizing that decisions on EMU membership are taken in the context of the competent European fora, Directors pointed to the importance of formulating a clear strategy for the objective of joining ERM II and eventually adopting the euro, which should include consideration given to how to target monetary policy in the ERM II framework. They therefore welcomed the establishment of a working group to build consensus for such a strategy. Most Directors called attention to the advisability of achieving durable and broad convergence with euro area countries in advance of the currency conversion.

Directors were encouraged by the fundamental soundness of Hungary's financial system and the continued progress in the regulatory and supervisory frameworks. They referred, however, to the potential risks, such as the rapid growth in consumer, business property, and mortgage lending--the latter being fueled by open-ended and unsustainable government interest subsidies. Directors urged the authorities to continue to monitor these risks carefully, including through the work of the central bank's *Financial Stability Report* and the activities of the Financial Supervisory Agency.

Directors commended recent structural reform initiatives, including plans to complete privatization and the recent increase in the regulated price of electricity and corresponding elimination of subsidies, and encouraged them to continue their efforts. While noting that the price of natural gas for some users is still considerably below world market levels, they welcomed recent plans to lessen gas pricing distortions.

Directors welcomed the steps taken by the authorities to increase the efficiency of the fight against money laundering, through an amendment of the anti-money laundering law. They also welcomed the strengthening of anti-terrorism financing efforts, with the improvement in operations and authority of the Financial Intelligence Unit.

Directors observed that Hungary's continued participation in updating Reports on the Observance of Standards and Codes modules is testament to its commitment to adopting international best practices. They welcomed the authorities' additional efforts to improve fiscal transparency and the quality of economic statistics.

Directors warmly welcomed the authorities' decision, in the context of the Heavily Indebted Poor Countries Initiative, to provide debt relief on all of Hungary's claims on a number of heavily-indebted less developed countries.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Hungary is also available.

Hungary: Main Economic Indicators

	1999	2000	2001	2002	2003 Staff Proj. 1/
Real economy (change in percent)					
Real GDP	4.2	5.2	3.8	3.3	3.6
CPI (average)	10.0	9.8	9.2	5.3	5.3
CPI (end-year)	11.2	10.1	6.8	4.8	5.3
Unemployment rate (percent)	7.0	6.4	5.7	5.8	6.0
Gross national saving (percent of GDP)	23.4	24.9	23.9	22.2	21.1
Gross domestic investment (percent of GDP)	28.5	31.1	27.3	26.3	25.9
General government (percent of GDP, ESA-95 basis) 2/					
Balance	...	-3.0	-4.7	-9.5	-4.5
Debt	61.0	55.4	52.4	56.8	55.3
Money and credit (end-year, percent change)					
M3 3/	13.1	18.1	17.1	9.5	14.2
Credit to non-government 3/	21.5	34.8	18.2	22.2	22.7
Interest rates (percent)					
T-bill (90-day, average) 3/	14.6	10.8	10.7	8.8	6.1
Government bond yield (five-year, average) 3/	11.8	9.1	8.5	7.7	6.5
Balance of payments					
Trade balance (percent of GDP)	-4.5	-6.2	-4.3	-3.3	-4.0
Current account (percent of GDP)	-5.1	-6.2	-3.4	-4.1	-4.8
Gross international reserves					
Billions of U.S. dollars 3/	11.0	11.2	10.8	10.4	14.0
In months of imports of goods and services 4/	4.1	3.7	3.3	2.7	3.8
Net external debt (percent of GDP) 5/	22.5	25.4	23.4	23.2	...
Fund position (February 28, 2003)					
Quota (SDR millions)				1,038.	
Holdings of currency (in percent of quota)				58.1	
Holdings of SDRs (SDR millions)				...	
Exchange rate					
Exchange regime	Peg against euro with band +/- 15 percent				
Present exchange rate (March 31, 2003)	Forint 226.5 = US$1				
Real effective rate, CPI basis (1990=100)	135.2	136.0	146.8	162.9	...

Sources: Data provided by authorities; *IFS*; and IMF staff estimates.

1/ These projections assume the government achieves its fiscal deficit target in 2003.

2/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments.

3/ Data for 2003 are as of end-February.

4/ Data for 2003 are as of end-February and expressed in terms of imports in 2002.

5/ Including inter-company loans, and nonresident holdings of forint denominated assets.